Petition

81-322

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No. 81-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

THE FIRST NATIONAL BANK OF SCOTIA,
KENNETH E. BUHRMASTER and
LOUIS H. BUHRMASTER,
Petitioners,

v.

UNITED STATES OF AMERICA DEPARTMENT
OF THE TREASURY and OFFICE OF THE
COMPTROLLER OF THE CURRENCY,
Respondents.

PETITION OF THE FIRST NATIONAL BANK OF SCOTIA, KENNETH E. BUHRMASTER and LOUIS H. BUHRMASTER, FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

QUESTION PRESENTED FOR REVIEW

Did the court of appeals, in upholding a decision of the Comptroller of the Currency that a lease of banking facilities was an investment in bank premises in violation of 12 U.S.C. § 371d, err by ignoring this Court's conflicting decision in Frank Lyon Co. v. United States, 435 U.S. 561 (1978)?

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No. 81-_____

In the Supreme Court of the United States
October Term, 1981

THE FIRST NATIONAL BANK OF SCOTIA,
KENNETH E. BUHRMASTER and
LOUIS H. BUHRMASTER,

Petitioners,

vs.

UNITED STATES OF AMERICA, DEPARTMENT
OF THE TREASURY and OFFICE OF THE
COMPTROLLER OF THE CURRENCY,

Respondents.

PETITION OF THE FIRST NATIONAL BANK OF SCOTIA,
KENNETH E. BUHRMASTER and LOUIS H. BUHRMASTER
FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Second Circuit

Petitioners The First National Bank of Scotia, Kenneth E. Buhrmaster and Louis H. Buhrmaster respectfully pray that a writ of

certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on April 9, 1981.

OPINIONS BELOW

The opinion of the court of appeals, not reported, the recommended decision of the administrative law judge and the opinion of the Comptroller of the Currency appear in the appendix hereto.

JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered on April 9, 1981. A timely petition for rehearing was denied on May 20, 1981, and this petition for certiorari is filed within 90 days of that date. The jurisdiction of this Court is invoked under 12 U.S.C. § 1818(h) and 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

United States Code, Title 12:

§ 371d

> No national bank, without the approval of the Comptroller of the Currency, and no State member bank, without the approval of the Board of Governors of the Federal Reserve System, shall (1) invest in bank premises, or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such bank, or (2) make loans to or upon the security of the stock of any such corporation, if the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any such corporation which is an affiliate of the bank, as defined in section 221a of this title, will exceed the amount of the capital stock of such bank.

STATEMENT OF THE CASE

The First National Bank of Scotia, Scotia, New York ("Bank") is a national banking association, chartered and examined by the Office of the Comptroller of the Currency ("Comptroller") under the National Bank Act,

12 U.S.C. §§ 27 and 481 [1] and is an insured bank within the meaning of the Financial Institutions Supervisory Act of 1966, as amended, 12 U.S.C. § 1818. Kenneth E. Buhrmaster is chairman of the board and chief executive officer of the Bank (App. at C-8). Louis H. Buhrmaster is President of the Bank (App. at C-8).

The Bank's management had decided to open a branch in Schenectady, New York, but lacked the equity capital required by 12 U.S.C. § 371d to purchase or construct a suitable building for that purpose. Under § 371d, "[n]o national bank, without prior approval of the Comptroller of the Currency . . . shall invest in bank premises" if the amount of the investment "will exceed the amount of the capital stock of such bank."

1/ Except as otherwise noted, all citations to applicable banking statutes will be to the current version and to 12 U.S.C.

The Bank instead decided to lease a building from the J. H. Buhrmaster Company ("Company") with an option to purchase. The Company is wholly owned by members of the Buhrmaster family and is primarily engaged in the business of selling heating oil (App. at C-16, C-53). Louis and Kenneth Buhrmaster are stockholders and directors of the Company (App. at C-15).

Under the lease agreement, the Company agreed to develop real estate as a branch banking facility and to lease that facility to the Bank (App. at C-53-54). 2/ The agreement provided that the rental payments would equal the Company's costs (including principal and interest) and that the Bank would pay all other costs, including taxes, associated with maintenance and operation of the facil-

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2/ The Comptroller found that the 1974 lease agreement (App. at E-1) set forth the true terms of the lease between the parties, a finding petitioners do not dispute (App. at C-54-56).

ity (App. at E-8-12, C-55). The agreement further obliged the Bank to compensate the Company for depreciation of the bank facility (App. at E-9, C-61). The Bank acquired the option to purchase the facility anytime during the term of the lease at a price equal to the Company's unreimbursed costs (App. at E-10-11, C-55-56).

The Company obtained the construction financing and permanent mortgage notes from the Schenectady Savings Bank, an independent third party (App. at C-56, C-58, F-1). The Bank paid $500,000 of the construction costs, but assumed no liability for repayment of those notes and mortgages (App. at E-12-13, C-56).

On February 13, 1980 the Comptroller issued a notice of charges under 12 U.S.C. § 1818(b)(1) against the Bank and Kenneth and Louis Buhrmaster charging inter alia that the Bank's lease of the Company's property con-

stituted an investment in Bank premises which violated 12 U.S.C. § 371d. [3/] After a hearing on this charge before an administrative law judge, the Comptroller on November 20, 1980 found that the Bank's agreement of April 11, 1974 to lease its branch on Erie Boulevard, Schenectady, New York, from the Company was not a true leasing agreement, but was instead a financing arrangement under which the lessee bank should constructively be considered the true owner of the leased facility (App. at D-2, C-56). [4/]

3/ First National Bank of Scotia v. Comptroller of the Currency, No. 80-4256 (2d Cir. Apr. 9, 1981) reprinted in the Appendix at A-1. The Comptroller on February 13, 1980 also issued under 12 U.S.C. § 1818(c)(1) a temporary order to cease and desist. The notice and temporary cease and desist order made other charges of unsafe and unsound banking practices that are not raised in this petition.

4/ The Comptroller's opinion and cease and desist order found unsound banking practices under § 1818 of which petitioners do not seek review.

On April 9, 1981 the United States Court of Appeals for the Second Circuit, under 12 U.S.C. § 1818(h), upheld the Comptroller's finding of a violation of 12 U.S.C. § 371d as supported by substantial evidence (App. at A-6-8). On May 4, 1981, the Bank and the Buhrmasters petitioned the court of appeals for rehearing on the ground that the court and the parties overlooked this Court's decision in Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1977). The court denied that petition on May 20, 1981 (App. at B-1).

The Bank and the Buhrmasters now seek a writ of certiorari on the ground that the decision of the court of appeals directly conflicts with this Court's decision in Lyon and misinterprets 12 U.S.C. § 371d.

REASONS FOR GRANTING THE WRIT

In Frank Lyon Co. v. United States, supra, 435 U.S. at 561, this Court upheld an

agreement to lease banking facilities entered into by the Worthen Bank & Trust Company with the Frank Lyon Company in order to avoid violating 12 U.S.C. § 371d and state banking regulations. The court of appeals wholly ignored this Court's decision and thus incorrectly interpreted § 371d.

The facts of Lyon are virtually identical to the facts of this case. 5/ Worthen

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5/ Frank Lyon Co. v. United States, supra, 435 U.S. at 561 (1977), was not cited in the briefs on the merits filed in the court of appeals. Petitioners' counsel before the court of appeals maintains a general practice with no specialization in banking regulation and was unaware of the Lyon decision. Petitioners' present counsel, retained after the court of appeals decision on April 9, 1981, immediately petitioned for rehearing, citing Lyon.

Although counsel for the Comptroller specializes in banking regulation, he did not call the court of appeals attention to Lyon in spite of its clear application. As a government attorney, the Comptroller's counsel "is the representative not of an ordinary party to a controversy, but of a sovereignty

(Footnote Number 5 Continued).

desired to construct a new banking facility. Id. at 563-65. It originally planned to finance, build and own the facility, but Worthen had to abandon such plans in part because it was denied permission under § 371d to invest in a facility in excess of its equity capital. Id.

As a result, Worthen entered into a sale and leaseback arrangement with Lyon, under which Worthen sold the building to Lyon as it was constructed and leased it back under "net" terms such that the rent equaled Lyon's cost (including principal and interest) and Worthen paid all other costs associated with

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(Footnote continued from previous page).

> whose obligation to govern impartially is as compelling as its obligation to govern at all." Berger v. United States, 295 U.S. 78, 88 (1934). His interest, therefore, is not to win a case, "but that justice shall be done." Id. at 88. Petitioners know of no explanation for the government's failure to call Lyon to the attention of the court of appeals.

operation of the bank facility. Id. at 565-67. Worthen also acquired an option to purchase for unreimbursed costs, primarily the unpaid balance of the mortgage. 6/ Id.

The Frank Lyon Company was a closely held corporation engaged in distribution of home furnishings. Frank Lyon was its majority shareholder and board chairman; he also was a director of Worthen. Id. at 563. Lyon entered into an interim and permanent financing agreement with a third party, New York Life, which Worthen joined as owner of the fee and parking lot. Id. at 568.

Lyon reported rental income and deducted expenses as the owner of the building. Id. The Internal Revenue Service challenged Lyon's resulting tax payment as insufficient on the ground that the sale-and-lease-back

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6/ Under the purchase option, Worthen would repay with token interest a $500,000 construction investment by Lyon not covered by the mortgage. Lyon, supra at 567.

arrangement was "a financing transaction in which Lyon loaned Worthen $500,000 and acted as a conduit for the transmission of principal and interest from Worthen to New York Life," id. at 569, making Worthen "the true owner of the building," id. at 570. This Court ruled that the lease agreement was not a sham because it was compelled by restrictions imposed by state and federal banking requirements, including § 371d, and because Lyon was primarily liable on the mortgage and finance notes. Id. at 575-83. This Court found the arrangement to be a "genuine multiple-party transaction compelled or encouraged by business or regulatory realities," and required that the "Government should honor the allocation of rights and duties effectuated by the parties." Id. at 583-84.

The court of appeals ignored both the existence and the rationale of the Lyon case. Instead, like the Comptroller, the court of

appeals relied on subjective evidence, such as the director interlock between the Company and the Bank and the lack of expectation of a profit or loss by the Company because of the "net" lease and the terms of the Bank's option (App. at A-7-8). But that fact pattern also was present in Lyon. Here, as in Lyon, "the objective economic realities of a transaction", id. at 573, show the court of appeals decision to be erroneous.

First, as in Lyon, the regulatory realities required the Bank to work with a third party lessor to obtain banking facilities. See id. at 575-76. As a result of § 371d, the transaction necessarily involved three parties: the lessee bank; the lessor investor; and the lender mortgagee. See id. Had the Company not been willing to undertake the transaction, the restrictions of § 371d would force the Bank to find another developer-lessor, since it was prohibited from inves-

ting in the bank facility. See id. The interrelationship of management did not undo the validity of the lease agreement. Id.

Second, as in Lyon, the Company is liable for payment of the mortgage, and has assumed the risk that the Bank would be unable to make its payments or possibly fail altogether. See id. at 577. 7/ Even more than in Lyon, the Company thereby has "exposed its very business well-being to this real and substantial risk." 8/ Id. at 577. Like Lyon, the Company, which engages in a substantial fuel oil business unrelated to real

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7/ In finding an arm's-length lease, the Court in Lyon emphasized that Lyon was not a shell corporation created only to hold title to the bank facilities, but was an ongoing business not created or even financed in anyway by Worthen. Lyon, supra, 434 U.S. at 580. Likewise, the Company cannot be considered a shell, created or financed by the Bank to hold title to the premises.

8/ The Scotia Bank, unlike the Worthen Bank, was believed by the Comptroller to have a strong potential for failure (App. at C-37-38).

estate investment, reports this indebtedness on its financial statement and is thereby "less able to obtain financing for other business needs." Id. Under Lyon this significant exposure establishes that the Company is the real owner of the bank facility. Id. at 576-79. The court of appeals holding of sham based on the "net" lease and the favorable terms under the option to purchase thus directly conflicts with Lyon.

Moreover, the court of appeals finding that the Bank has invested in bank premises conflicts with the plain language of the statute and its legislative purpose. Payments by a bank under a lease arrangement are not an investment in bank facilities. Perth Amboy National Bank v. Brodsky, 207 F. Supp. 785, 78 (S.D.N.Y. 1962). 9/ The factors re-

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9/ Lyon recognized that the accounting principles for disclosing lease agreements set forth in Financial & Account-

(Footnote Number 9 Continued).

lied upon by the court of appeals, particularly the favorable terms of the lease and option to purchase and the interrelationship of management, do not bring the subject lease agreement within the proscription of § 371d. Rather these terms benefit the Bank and further the purpose of the statute by potentially adding to the Bank's capital assets. As the Bank is not liable for repayment of the mortgage, its assets are subject to no risk as a result of obtaining the subject banking facilities. In accordance with the legislative purpose of § 371d, the Bank's assets

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ing Standards Board, Statement of Financial Accounting Standards No. 13, Accounting for Leases (1976) were nonapplicable to leases executed prior to January 1, 1977 until January 1, 1981. Lyon, supra, 435 U.S. at 577-78 n.14. Lyon also recognized that characterization of a transaction for accounting purposes may not be the same as for other purposes, such as tax reporting. Id. at 577. "Accounting methods without more do not lend substance to that which has no substance." Id.

have not been diverted into speculative ventures and are fully protected from liability under the subject lease agreement. 10/ See H.R. Rep. No. 150, 73d Cong., 1st Sess. 1 (1933). The court of appeals decision that the terms of the lease constitute an illegal investment in the banking facilities thus also misconstrues the plain meaning of § 371d.

10/ According to undisputed testimony, the total amount of the lease payments by the Bank to the Company were reasonable. Testimony of Lewis Swyer, Jt. App. at 315a-17a. The Comptroller, however, like the IRS in the Lyon case, reallocated the depreciation expense, and prohibited the Bank from reimbursing this expense to the Company. Lyon, supra, 435 U.S. at 569.

CONCLUSION

For the foregoing reasons, Petitioners The First National Bank of Scotia, Kenneth Buhrmaster and Louis Buhrmaster respectfully pray that a Writ of Certiorari be granted.

Respectfully submitted,

By: _____

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EXHIBIT A

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the ninth day of April, one thousand nine hundred and eighty-one.

Present: HON. WILLIAM H. TIMBERS,) Circuit
HON. JON O. NEWMAN,) Judges

HON. ABRAHAM D. SOFAER,) District Judge Sitting by Designation

Filed Apr. 9, 1981

THE FIRST NATIONAL BANK OF SCOTIA, KENNETH E. BUHRMASTER, and LOUIS H. BUHRMASTER,	)	
Petitioners,	)	Docket No. 80-4256
v.	)	
UNITED STATES OF AMERICA, DEPARTMENT OF THE TREASURY, OFFICE OF THE COMPTROLLER OF THE CURRENCY,	)	
Respondents.	)	

Petition to review an order of the United States Department of the Treasury, Office of the Comptroller of the Currency.

This cause came on to be heard on the record of the Office of the Comptroller of the Currency and was argued by counsel.

Upon consideration thereof, it is hereby ordered, adjudged and decreed that the petition to review is denied and the order of the Comptroller of the Currency is affirmed.

Petitioners First National Bank of Scotia (the Bank), Kenneth E. Buhrmaster and Louis H. Buhrmaster, officers of the Bank, have petitioned pursuant to 12 U.S.C. § 1818(h)(2)(1976) to review a cease and desist order issued by the Department of the Treasury, Office of the Comptroller of the Currency (the Comptroller).

Pursuant to procedures provided by 12 U.S.C. § 1818(b), the Comptroller determined that the Bank had engaged in numerous unsafe and unsound banking practices and had violated 12 U.S.C. § 371d (1976). Accordingly, the Comptroller issued an order on Novem-

ber 20, 1980 requiring petitioners to cease and desist from those practices and to engage in specified affirmative action to correct the conditions resulting from those violations and practices.

Petitioners do not dispute the Comptroller's finding that the Bank had been operating with insufficient equity capital and that without an additional $1.5 million in equity capital the Bank was likely to suffer a capital insolvency in the foreseeable future.

Petitioners do contend that the remedial measures ordered by the Comptroller to remedy that deficiency are beyond the scope of his statutory powers. We disagree.

The statute under which the cease and desist order was issued, 12 U.S.C. § 1818 (1976), was enacted to provide the Comptroller with broad authority -- short of the "last resort" of appointing a conservator or

withdrawing a bank's federally insured status -- to employ "flexible and effective supervisory powers" to avoid bank failures and to limit the losses from ongoing improper practices. S. Rep. No. 1482, 89th Cong., 2d Sess. (1966), reprinted in [1966] U.S. Code Cong. & Ad. News, at 3532, 3536-38; see In re Franklin Nat. Bank Sec. Litigation, 478 F.Supp. 210, 218-19 (E.D.N.Y. 1979). Consistent with that purpose, the statute gives the Comptroller broad authority to identify unsafe and unsound banking practices, Groos National Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5 Cir. 1978), and equally broad authority to fashion remedial orders to require banks not only to "cease and desist" from such practices, but also to take affirmative action to correct the conditions resulting from those practices.

In view of the extreme circumstances present in this case and the broad remedial

purpose of the statute, we hold that the Comptroller did not exceed his authority in ordering petitioners to increase the Bank's capitalization by $1.5 million and in ordering petitioners to submit "realistic proposals" for the sale or merger of the Bank in the event it were unable to raise the required capital.

We do not interpret the Comptroller's order as necessarily requiring the Bank to issue capital stock without the approval of its shareholders under 12 U.S.C. § 57, or to sell the Bank's assets or to consolidate without such approval in accordance with 12 U.S.C. §§ 214a, 215. Even if the order did so require, however, we would not hold that it exceeded the Comptroller's statutory authority under the circumstances of this case. As stated above, Congress has granted to the Comptroller broad and flexible powers to enable him, among other things, to shore

up banks, like the petitioner Bank here, which face failure. Capital adequacy long has been regarded as an important measure of soundness, Board of Governors v. First Linwood Corp., 439 U.S. 234, 250 (1978), which is within the scope of that power.

In the event of a bank failure, it should be remembered, the Comptroller would have even broader power to dissolve a bank without shareholder approval, 12 U.S.C. § 181 (1976), Minichello v. Saxon, 337 F.2d 75 (3 Cir. 1964), cert. denied, 380 U.S. 952 (1965), or to order the sale of a bank's assets without allowing the shareholders and directors to adopt their own plan for doing so. 12 U.S.C. § 203 (1976); In re Conservatorship of Wellsville Nat. Bank, 407 F.2d 223 (3 Cir.), cert. denied, 396 U.S. 832 (1969).

We also hold that the Comptroller's finding that the Bank has violated 12 U.S.C. § 371d (1976) by investing in bank premises

on Erie Boulevard in Schenectady, New York, is supported by substantial evidence. Consolo v. Federal Maritime Commission, 383 U.S. 607, 620 (1966).

The evidence clearly supported the Comptroller's finding that the so-called lease agreement between the Bank and the J. H. Buhrmaster Co. dated April 11, 1974 was not a true lease but a device intended to hide the Bank's illegal investment in the Bank's premises. Among other things, it is significant that Buhrmaster Co. entered into the relationship without hope of a profit or fear of a loss; that essentially all of the costs of construction and maintenance were borne by the Bank; and that the Bank was granted an option to buy the premises at a greatly reduced price. Also significant is the identity of management between the Bank and its ostensible landlord, which belies petitioners' contention that this was an "arm's-

length" transaction. We hold that the Comptroller's finding is supported by uncontroverted evidence of deceptive practices which petitioners engaged in to hide the true nature of the investment agreement.

Where the Comptroller's finding of a violation is supported by substantial evidence, he is given broad discretion to order remedial measures. His exercise of that discretion will be disturbed only if it is arbitrary and capricious or beyond the scope of his statutory authority. First National Bank of Eden v. Comptroller of the Currency, 568 F.2d 610, 611 (8 Cir. 1978); see Groos National Bank v. Comptroller, supra, 573 F.2d at 897. We hold that the Comptroller did not act in an arbitrary and capricious manner; nor did he exceed his authority by ordering the Bank to stop making payments under the sham agreement found to be unsound; nor by ordering the named directors of the Bank to

take affirmative measures to correct the conditions caused by those improper payments by making restitution for improper payments the Bank is otherwise unable to recoup.

WILLIAM H. TIMBERS
UNITED STATES CIRCUIT JUDGE

JON O. NEWMAN
UNITED STATES CIRCUIT JUDGE

ABRAHAM D. SOFAER
UNITED STATES DISTRICT JUDGE
Sitting by Designation

EXHIBIT B

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 20th day of May, one thousand nine hundred and eighty-one.

Present: HON. WILLIAM H. TIMBERS,) Circuit
HON. JON O. NEWMAN,) Judges

) District
HON. ABRAHAM D. SOFAER,) Judge

THE FIRST NATIONAL BANK OF SCOTIA, KENNETH E. BUHRMASTER and LOUIS H. BUHRMASTER, Petitioners,	Docket No. 80-4256
v.	
UNITED STATES OF AMERICA, DEPARTMENT OF THE TREASURY OFFICE OF THE COMPTROLLER OF THE CURRENCY, Respondent.	

Filed May 20, 1981

A petition for a rehearing having been filed herein by counsel for the Petitioners,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

/s/ A. Daniel Fusaro
Clerk

EXHIBIT C

UNITED STATES OF AMERICA
DEPARTEMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF THE FIRST NATIONAL BANK OF SCOTIA, SCOTIA, NEW YORK: KENNETH E. BUHRMASTER: and LOUIS H. BUHRMASTER	)

ORDER CERTIFYING RECORD TO THE COMPTROLLER FOR DECISION

The above-entitled matter is hereby certified to the Comptroller of the Currenty for decision. Forwarded herewith is the entire record of the hearing, which includes my recommended decision, findings of fact, conclusions of law and recommended order, the transcript, exhibits, rulings and all briefs and memoranda filed in connection with the hearing.

/s/ John J. Mathias
Administrative Law Judge

June 27, 1980

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF FIRST NATIONAL BANK OF SCOTIA, SCOTIA, NEW YORK: KENNETH E. BUHRMASTER: and LOUIS H. BUHRMASTER

RECOMMENDED DECISION

John J. Mathias
Administrative Law Judge

June 27, 1980

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UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF THE FIRST NATIONAL BANK OF SCOTIA, SCOTIA, NEW YORK; KENNETH E. BUHRMASTER: and LOUIS H. BUHRMASTER	)

RECOMMENDED DECISION

John J. Mathias, Administrative Law Judge

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Council for the Office of the Comptroller of the Currency

Bernard T. McGivern, Esq.
McGivern, Shaw & O'Connor

Counsel for Respondents

PRELIMINARY STATEMENT

On February 15, 1980, the Office of the Comptroller of the Currency (complainant) caused a Notice of Charges to be served upon The First National Bank of Scotia, Scotia, New York, Kenneth E. Buhrmaster and Louis H.

Buhrmaster (respondents) setting forth a statement of the facts constituting certain alleged violations and unsafe or unsound banking practices, as required by 12 U.S.C. § 1818(b)(1). The Notice of Charges was dated February 13, 1980 and set the hearing date for April 7, 1980; such hearing to be conducted in accordance with Chapter 5 of Title 5 of the United States Code as required by 12 U.S.C. § 1818(b)(1).

The respondents served an answer to the Notice of Charges on complainant denying the substantive charges against them. The hearing on the charges commenced on April 8, 1980, an adjourned date agreed upon by the parties. Complainant called seven witnesses during its case-in-chief and introduced 85 exhibits (with the exception of one number which was not used and one exhibit which was withdrawn) to support its case against respondents. Respondents called nine witnesses

in their defense and offered 60 exhibits in evidence, one of which was withdrawn and another which was rejected as duplicative. The hearing consumed a total of six trial days and 868 pages of transcript.

Respondent First National Bank of Scotia (hereinafter Scotia Bank) is a national banking association. Respondent Kenneth E. Buhrmaster is and was the Chairman of the Board and chief executive officer of the respondent bank during the relevant period of time and respondent Louis H. Buhrmaster is and was its president. The Notice of Charges basically alleges seven unsafe and unsound banking practices in which the respondents allegedly have been engaged, 1/ and it also charges that they have violated three specified regu-

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1/ The Notice of Charges actually contained 17 charging paragraphs, in some instances with a number of subparagraphs, detailing the substantive charges against respondents. However, these can all be summarized as representing seven separate, basic charges.

lations. Such basic allegations are:

1. The respondent bank is and has been operating with inadequate capital with relation to the condition of the bank, the quality of its assets, the amount and quality of its earnings, the size of its personnel and occupancy expenses, the size of its dividends and the quality of its management (Article II);

2. The chief executive officer has been unable or unwilling to direct the affairs of the bank in a safe and sound manner (Article III);

3. Respondents have invested in the bank's Erie Boulevard Branch in violation of 12 U.S.C. § 371d, and engaged in other improper unsafe and unsound banking practices in connection with such branch operation (Articles IV and V);

4. Respondents have accumulated an ex-

cessive amount of poor quality assets (Article VI);

5. Respondents have operated the bank without an adequate allowance for possible loan losses (Article VII);

6. Respondents have failed to develop and implement adequate auditing procedures at the bank and have failed to hire a full-time, capable internal auditor (Article VIII);

7. Respondents have failed to develop acceptable programs to reduce the bank's reliance on rate-sensitive funds, improve the bank's earnings, and reduce the bank's occupancy and personnel expenses (Article IX); and

8. Respondents have failed to comply with certain rules and regulations; namely:

(a) 12 C.F.R. § 1.8 in that the bank filed to maintain sufficient credit information in its files to demonstrate

it had exercised prudence in purchasing securities;

(b) 12 C.F.R. § 7.3025 in that the bank: filed in several instances to obtain proper appraisals of the fair market value of "Other Real Estate Owned" ("OREO"); failed to record several properties held as OREO at the lower of cost or fair market value; failed to obtain annual appraisals on certain properties held as OREO to determine that the properties had not declined in value; did not, as a general practice, maintain current documentation to show that it was diligently trying to dispose of its OREO within 5 years; and made additional advances to complete construction on certain properties without obtaining documentation which demonstrated that the advances would make the property more marketable; and

(c) 31 C.F.R. § 103.33(a) in that the bank, in several instances, made loans over $5,000 not secured by real estate without obtaining a statement of the nature or purpose of the loan.

The complaint further charges, in connection with some of these alleged violations, that the bank has violated an agreement or agreements with the Comptroller (OCC) designed to correct certain of these alleged deficiencies. (See Articles II, VI, VII, and IX of the Notice of Charges.) It is further charged that the bank's occupancy and personnel expenses are excessive as compared to a "peer group" of banks. The latter charge was made on the basis of the National Bank Surveillance System report (NBSS). The "peer group" for the Scotia Bank consists of 260 national banks having assets between $40 million and $100 million, with two or more branches, and which are located in a high

density population area (a Standard Metropolitan Statistical Area -- SMSA).

This recommended decision is based upon the entire record including proposed findings of fact and conclusions of law and supporting memoranda filed by the parties, as well as their replies. I have also taken into account my observation of the witnesses who appeared before me and their demeanor. Proposed findings not herein adopted, either in the form submitted or in substance, are rejected either as not supported by the evidence, or as involving immaterial matters.

The findings of fact sometimes include references to supporting evidentiary items in the record. Such references, where made, are intended to serve as guides to the testimony and exhibits supporting such findings. They do not necessarily represent complete summaries of the evidence supporting such find-

ings. The following abbreviations have been used herein:

Tr.- Transcript, followed by the page number and sometimes preceded by the name of the witness.

CX - Complainant's exhibit, followed by its number and the referenced page(s).

RX - Respondent's exhibit, followed by its number and the referenced page(s).

CF - Complainant's proposed findings.

RF - Respondent's proposed findings.

CRB - Complainant's reply brief.

RRB - Respondent's reply brief.

THE ISSUES

(1) Whether the OCC has met its burden of proof in establishing the accuracy of the allegations contained in the Notice of Charges by "reliable, probative and substantial evidence;"

(2) Whether a cease and desist order based on the Notice of Charges should issue against all or any of the respondents; and

(3) If a cease and desist order should be issued, what provisions should it contain.

FINDINGS OF FACT

I. JURISDICTIONAL FACTS

The First National Bank of Scotia is a national banking association chartered and examined by the Comptroller, pursuant to the National Banks Act of 1864, 12 U.S.C. §§ 27 and 481. Said bank is an insured bank within the meaning of 12 U.S.C. § 1818.

Kenneth E. Buhrmaster is the Chairman of the Board and the Chief Executive Officer of the Scotia Bank and has held these positions since prior to 1966. He is also a 33% shareholder of the J. H. Buhrmaster Company.

Louis H. Buhrmaster is the President of the respondent bank and has held this position since approximately 1969. He is also a 34% shareholder of the J. H. Buhrmaster Company.

The J. H. Buhrmaster Company is wholly owned by various members of the Buhrmaster family.

II. THE BANK'S CAPITAL

The primary purpose of equity capital for a financial institution is to support the level of its operations and provide adequate protection for its depositors' funds. In determining what is an adequate level of protection for Scotia Bank, a number of factors must be considered, including: the quality of its assets, the amount and quality of its earnings, its retention of earnings, the nature of its liabilities, its personnel and occupancy expenses, its dividends, the quality of its management and the general condition of the bank. It is also instructive in this regard to compare its performance and level of equity capital with those of other

banks of similar size and characteristics located in similar market areas.

A. The Scotia Bank's Equity Capital Is Inadequate.

The weight of the evidence herein reveals that the equity capital of this bank is so inadequate that, if additional equity capital is not injected into it, a capital insolvency of the bank is likely in the foreseeable future. The Scotia Bank has had a rapid deterioration in its equity capital over the past three years. For example, the decline in equity capital between 12/31/78 and 12/31/79 amounted to over $500,000 (CX 22D). Since the Par Value and Surplus accounts of the bank have remained constant over the last three years, a good indication of the deterioration of the bank's equity capital is its Undivided Profits account, which has declined from $167,000 as of 12/31/77 to a minus $381,000 as of 12/31/79

(CX 22D). During this time the branch has been unable to generate equity capital through retained earnings and it has been extremely reluctant to attempt raising equity capital from external sources.

The Scotia Bank's earnings and retained earnings record is dismal and its prospects for improvement in these areas in the near future do not appear bright. Over the past six years equity growth from retained earnings has been a minus figure for all but two years, and in those two years, 1975 and 1976, such growth was very minimal (CX 22L). Respondents have produced no substantial evidence that they are about to reverse this trend.

In addition to an actual dollar decline in equity capital, the quality of the bank's assets has greatly deteriorated during the last couple of years, especially during the period September 1978 to April 1979 (CX 1B).

The level of classified assets according to the 1979 bank examination was about 104% of gross capital funds (CX 1B). 2/ Although respondents have introduced evidence to show that these classified assets have been reduced by about 30% between April 1979 and January 31, 1980, respondents' analysis addresses only the specific assets criticized and does not present an overall evaluation of all of the bank's assets (RX 41). In view of

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2/ It would appear that the 104% figure is slightly overstated. Respondents have demonstrated that a portion of the installment loans criticized by the examiner, the discount portion, should be deducted from the total dollar amounts of such criticized assets (RX 43). Deduction of the amount involved ($119,699) would still leave the ratio of classified assets to gross capital at over 100%. Other objections to the examiner's listing of classified assets have less substance, but even if all such objections were fully credited, along with reductions in classified assets claimed to have been made by respondents since the examination (RX 41), the percentage of criticized assets to gross capital funds would still be substantially above the 25% considered acceptable by complainant's expert (Vaez, Tr. 307). It is notable that no witness for respondents has taken issue with this 25% limit.

the bank's previous record, it cannot be assumed that other assets have not degenerated into a classified status during this same period. Thus, without a broader view of the quality of the bank's assets in January 1980, respondents' evidence does not rebut the evidence of complainant.

Another threat to the bank's precarious equity capital situation is its heavy reliance on rate-sensitive liabilities which are not being properly utilized to fund rate-sensitive assets. The use of rate-sensitive liabilities to fund other than rate-sensitive assets creates both (1) a liquidity problem and (2) an interest rate risk which directly impacts on the earnings and on the capital accounts of the bank. 3/ Although the bank

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3/ The interest rate risk is caused by the fact that the rate-sensitive liabilities are being maintained in escalating interest rate markets at a higher cost. When they are used

(Footnote Number 3 Continued).

has taken steps to minimize the liquidity problem, the continued substantial imbalance in rate-sensitive liabilities vis-a-vis rate-sensitive assets continues to have an adverse effect on the bank's interest earnings (CX 22N). Such imbalance, since it is affecting its earnings, also has a direct effect on the capital needs of the bank.

The bank's capital deficiency is also impaired by the excessive dividends paid over the past several years (CX 22M). In fact, since mid-1977, the Scotia Bank has paid more in dividends to the shareholders than it has made through its banking operations.

(Footnote continued from previous page).

to fund other than rate-sensitive assets, such as real estate mortgages which bear a flat rate of interest, the net interest margin, which is the difference between the interest income and the interest expense, continues to dwindle to the point where it is insufficient to derive net income after the payment of other expenses, the absorption of allowances for loan losses and the payment of excessive dividends this bank has made (CX 22N and P; Vaez, Tr. 311-12).

The 1979 examination also revealed deficiencies in the internal auditing procedures employed by this bank (CX 1). Although these deficiencies were not considered so severe that they could not be easily remedied, they do expose the bank to an unnecessary degree of risk.

Furthermore, the personnel expenses and occupancy expenses of this bank are very high, especially the occupancy expenses. The high personnel expenses have been exacerbated by recent salary increases to top bank executives, even though there have been some overall reductions in this area over the last two years.

All of these factors, of course, reflect heavily on the quality of management of the Scotia Bank and on the overall condition of the bank. In view of these facts, the bank management's performance over the last several years must be considered quite poor.

The degree of peril in which this bank has been placed by its management is exemplified by the quality of the bank's assets, the very poor earnings performance, the payment of excessive dividends, the risks taken on the funding side, and deficiencies in internal auditing procedures. 4/ Thus, poor management is a factor which must be considered in connection with the bank's capital needs.

In addition to these qualitative factors, a number of quantitative factors also can be used to show the degree of the bank's capital deficiency. These are ratio and performance analyses which show the bank's condition over a period of time.

For instance, the bank's return on equity has been very poor over the last several

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4/ Of course, the management's performance can also be judged as poor on the basis of the dealings surrounding the establishment and operation of its Erie Boulevard Branch in Schenectady. This topic is the subject of extensive discussion below in connection with the charges involving those dealings.

years, declining to only 2.84 in 1978 and a negative figure in 1979 (CX 22L). Respondent's own expert, Mr. Pacquereau, viewed this ratio as the number one ratio in reviewing a bank's performance (Tr. 787). 5/ This ratio, return on equity, is particularly significant in rating the performance of the bank's management. Historically, banks endeavor to maintain a yield of return on average equity of no less than 10% (Vaez, Tr. 329-330). The Scotia Bank has not attained that level in the last six years, and only came close in one year, 1975 (CX 22L).

Another ratio which is indicative of the quality of bank management and the bank's

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5/ It is quite significant that this was not one of the ratios which this witness was asked to produce for his peer group selection in his testimony for respondents. In fact, it is interesting to note that out of 40 types of ratios which this witness' company produces in its reports, he was only asked to include 3 of such ratios in his exhibits and return on equity, which he considered number one, was not included.

performance is "return on assets" (ROA). Again, the Scotia Bank's performance over the last several years has been poor. Its ROA went from a low of .26% in 1977, to only .14 in 1978 and a minus figure in 1979 (CX 22B).

Other quantitative factors considered by complainant's experts in reviewing the bank's performance and its need for additional equity capital are percentage of equity to total assets, risk assets as a percentage of equity capital, the ratio of cash dividends to average equity, the bank's equity growth from retained earnings, and cash dividends as a percentage of income. All of these factors reveal a poor performance record by the bank and each one of them shows a decline in the bank's performance (CX 22L-M).

B. Comparison With Other Banks of Similar Size, Type and Location.

Complainant's experts compared the performance of respondent bank with that of sim-

ilar sized national banks located in Standard Statistical Metropolitan Areas of similar size throughout the nation. This was done through the National Bank Surveillance System (NBSS), Bank Performance Report (BPR). The National Bank Surveillance System, created in 1975, contains statistics from regular reports filed by each of the National Banks. The NBSS data is fed into a computer for analysis and preparation of the Bank Performance Report. The BPR for respondent bank is a 22-page report analyzing the bank's performance through various financial data and significant statistical ratios and comparing such performance with the performance of the "peer group" selected for that bank. The "peer group" consists of banks that have similar size, in similar locations according to population density and which have a similar number of branches. In the case of the First National Bank of Scotia the peer group con-

sisted of 260 National banks and other Federal Reserve member banks having assets between $40 and $100 million at 12/31/78, with two or more full service branches and located in a high-density population area (SMSA) (CX 22A).

Respondents' experts have criticized this Report on the grounds that the NBSS does not give access to all commercial banks (only national banks and state banks which are members of the Federal Reserve System), 6/ and does not break down the data by states and/or regions. One of respondents' experts, Dr. Forbes, also believes that the NBSS data are improper because the "peer group" selected is too wide, in that it includes banks in the $80 to $100 million range and because such analysis does not consider the number of doc-

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6/ This group of national banks and other banks in the Federal Reserve System includes about 39% of all commercial banks (Pacquereau, Tr. 774).

uments a bank handles, the number of customers a bank serves, the mix of its deposits and the type of loans it makes (Tr. 799-800).

It is clear that insistence on the refinement of data which Dr. Forbes espouses would render a comparative analysis of a bank's performance practically impossible. Certainly a comparison of national banks and state banks within the National bank and Federal Reserve Systems, with similar number of branches and located in areas with similar competitive conditions would insure a sufficient degree of comparability to allow some meaningful conclusions to be drawn therefrom. As for his insistence that the grouping of banks with assets between $40 and $100 million constitutes a deficiency, such academic opinion conflicts with the practical experience of another of respondents' experts, Mr. Pacquereau, who espouses a grouping of banks with assets from $25 to $100 million (Pacque-

reau, Tr. 785). I must, therefore, dismiss these criticisms of the NBSS data as impractical and insubstantial.

As to the failure to include all commercial banks in the NBSS data, I do not find this to be a deficiency. The inclusion of only national banks and state banks within the Federal Reserve System complies to a certain degree with Dr. Forbes' desire to particularize the peer group selection so that it includes only banks with similar transactions, similar paperwork, etc. It also provides the OCC with a broader base of knowledge in analyzing the comparative data, since the Comptroller's office is familiar with these banks through close association and can identify problem banks and special characteristics which might affect any comparison.

On the other hand, there does seem to be some aberration involved when banks in cer-

tain states are compared to banks on a nationwide scale as to some characteristics. Certain factors, such as personnel expenses and occupancy expenses can differ greatly between the various states. In these specific areas of comparison, problems can arise when comparing banks within different states.

However, such differences should have little effect on all but a few areas of comparison. To the extent banks in a particular state have additional expenses, or other peculiar problems or constraints, such facts only indicate that management of those banks have a need to be more conservative than that of banks in states where the climate is more favorable. This means, for example, that in determining the sufficiency of equity capital to support the operations of a bank in such a state, the NBSS reports might be interpreted more strictly. Thus, such a bank may need a higher than average level of equity capital,

all other things considered, than the peer group level exhibited by the NBSS data. 7/

This fact is substantiated by CX 85, which is a comparison of the Scotia Bank within a more select "peer group" of 16 banks, all located within New York state, with total assets from $40 to $80 million. In comparing the First National Bank of Scotia with this peer group on the basis of nine selected ratios, it fares far worse than it did in the comparison with the national peer group. This exhibit also substantiates the basic reliability of the NBSS data in rating the performance of a bank, regardless of the state of location. Whether the Scotia Bank's performance is compared with a national peer

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7/ It is also important to note that the NBSS comparisons constituted only a part of the Comptroller's calculation of the Scotia Bank's equity capital needs. The more important considerations in that decision were the qualitative factors considered above, which revealed the poor condition of this bank and its management.

group or a local, New York peer group, its overall performance is still poor.

Moreover, respondents' own exhibits dealing with capital adequacy (RX 55 and 56) substantiate this fact. This highly selective statistical data (omitting the ratio which the preparer thereof considers the most important) for all commercial banks in New Jersey, Connecticut, Massachusetts and New York having assets of $25 to $100 million, still shows Scotia Bank in the bottom portion of the list and substandard, especially in New York (RX 55G and H; 56G and H). The usefulness of the NBSS data as a comparison tool is again confirmed.

Whether based on the entire 260 bank national "peer group," or the narrower New York "peer group," the comparative data utilized by the Comptroller's expert in assessing the bank's performance is probative. As to "return on equity," for instance, the national

peer group was consistently in the 10.5% to 11.5% range, whereas the Scotia Bank was at 4.99% in 1977, 2.84% in 1978 and a minus figure in 1979. The highest the Scotia Bank attained was 8.42% in 1975, and that was an anomaly when compared to the other years since 1974. Even with the New York peer group, the group average was 10.34% as of 12/31/79, as compared to respondent bank's minus 16.12% (CX 22L, 85). As for "return on assets," the national peer group remained in the .8% range throughout the six-year period beginning in 1974, whereas the Scotia Bank only got as high as .42% in 1975 and had percentages of .26, .14 and minus .84 the last three years. The New York peer group had an ROA of .84% in 1979, as compared to respondent bank's exactly opposite figure of minus .84% (CX 22B; 85).

Other quantitative factors show similar disparities when compared to these peer

groups. Equity as a percentage of total assets has declined for respondent bank over the last four years from a high of 5.58% to 4.84% while the national peer group has remained at about 7.5%. This statistic for the New York peer group reveals an average of 8.21% (CX 22L, 85). 8/ These figures for Scotia Bank show not only that its equity capital has been shrinking but that its equity capital is consistently and substantially lower than that of its peers. In view of the deteriorating quality of its assets, this is very serious.

The next factor considered by Mr. Vaez was the ratio of risk assets to equity capital. Again, the respondent bank compared

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8/ Even respondents' own exhibit dealing with commercial banks with 5 or more branches and assets of $25 to $100 million shows a percentage of equity capital to total assets in 1978 of 6.66% as compared to the Scotia Bank's 5.3%. Moreover, it shows that the Banc Analysis Report for 79 commercial banks with one or more offices had a percentage of 8.64% for this ratio.

very unfavorably. While its risk assets were hovering between 13.5 times and 14.5 times its equity capital for the last six years, the national peer group's figure remained under 10 times and the New York peer group was at 8.22 times equity capital (CX 22L, 85). This disparity was exacerbated by the poor quality of respondents' risk assets. (Risk assets are defined as all loans and investments other than government obligations).

The Comptroller's expert (Mr. Vaez) also compared this bank's ratio of cash dividends to average equity capital. Historically, this ratio has been substantially higher for the Scotia Bank than for the national peer group (CX 22L), thus revealing the payment of excessive dividends. The bank's equity growth from retained earnings shows a similar disparity. While the national peer group shows such growth at the rate of 7.5% to 9.05% over the past six years, and the New

York group had an 8.32% growth from this source in 1979, the respondent bank has shown a minus figure for four out of the last six years, with a high of 2.71% in 1975 (CX 22L, 85).

The last ratio used by complainant to compare respondent bank with its "peers," was the ratio of cash dividend declared to net income. The Scotia Bank has declared far more cash dividends than its earnings over the last few years, whereas the national peer group has stayed at about 30% of its net income in declaring dividends and the New York group paid about 21% of their net income as dividends in 1979 (CX 22M, 85). This certainly illustrates the vast difference in the operations of the respondent bank, as compared to more prudently managed institutions.

Lastly, in connection with complainant's use of comparative data as an aid in judging the level of performance of this

bank, it is important to consider the fact that Mr. Vaez, one of the complainant's experts, was familiar with all of the "problem banks" in the national banking system, and particularly with all "problem banks" in Region 2, which includes New York and New Jersey. 9/ It was his uncontradicted testimony that through his familiarity with such problem banks and his extensive analysis of the condition of the Scotia Bank that he was able to categorize this bank as having the greatest potential for failure of all banks in the national bank system (Vaez, Tr. 301, 335).

9/ Mr. Vaez is employed in the Special Projects Division of the Comptroller. His primary duties are to monitor problem banks as identified during the course of national bank examinations, to try to determine the underlying cause of the problems, assess and reassess the findings of the bank examiners and conduct a review of such findings subsequent to the review made by the Regional Administrator. He is presently assigned to Region 2, which includes New York and New Jersey.

C. Determination of the Bank's Equity Capital Requirements

The OCC has computed the bank's present equity capital needs to be $1.5 million. This determination has has been made through a subjective analysis of the bank's condition, as explained above, and through a comparison of its performance with a group of banks having similar characteristics. To illustrate the accuracy of this determination, complainant's expert, Mr. Vaez, has computed the bank's equity capital and projected shortfalls for maintaining unchanged leverage, as of 12/31/79 and for 1980. This calculation (CX 77J) reveals an equity shortfall for 12/31/79 of over $1.5 million. Respondents have not introduced evidence to rebut this determination. As noted above, they have shown that a portion of the classified

assets have been removed. 10/ However, they have failed to provide evidence of the overall condition of the bank's assets and, in view of trends over the last few years, it cannot be assumed that all other assets have remained unchanged and in a non-classified status. Moreover, even with the removal of

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10/ They have also introduced two exhibits which compare (1) Scotia Bank's equity capital as a percent of total assets and (2) its equity capital as a percent of net loans, with such ratios for certain other commercial banks in New Jersey, Connecticut, Massachusetts, and New York (RX 55 and 56). As noted above, these exhibits still show respondent bank to be substandard. But even more important is the fact that these two exhibits represent a continuing attempt by the bank's management, starting well before the Notice of Charges was filed, to find some quantitative ratio which would provide them with an easy way out. In May 1979 they attempted to convince the OCC that their equity requirements should be cut by two-thirds, based upon their equity formation from retained earnings (L. Buhrmaster, Tr. 603; CX 18; RX 12). Louis Buhrmaster admitted, however, that the Regional Administrator had previously made it clear to them that the bank should not be relying on ratios (Tr. 603). Just as respondents have been advised, it is the overall

(Footnote Number 10 Continued).

such assets from a classified status, the percentage of classified assets still remains far above a safe and sound level. Accordingly, the only substantial evidence of record indicates that $1.5 million is an accurate determination of this bank's shortfall in equity capital.

D. The Failure To Maintain An Adequate Level Of Equity Capital Is An Unsafe Or Unsound Banking Practice

The term "unsafe or unsound" banking practice has a broad interpretation under 12 U.S.C. § 1818(b)(1) and encompasses various problems occurring in the regulation of banking institutions. During the hearings on the Financial Institutions Supervisory Act of 1966 before the House of Representatives Com-

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(Footnote continued from previous page).

condition of the bank, considering particularly the qualitative factors discussed above, which determine its need for capital, not the results of one or a few comparisons on the basis of such ratios.

mittee on Banking and Currency, Mr. John Horne, then Chairman of the Federal Home Loan Bank Board, defined the term "unsafe and unsound" as follows:

> Like many other generic terms widely used in the law . . . the term "unsafe or unsound practices" has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an "unsafe or unsound practice" embraces any action or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequence of which, if continued would be abnormal risk or loss or damage to an institution, its shareholders or the agencies administering the insurance funds. (Financial Institutions Supervisory Act of 1966, Hearings Before the Committee on Banking and Currency, House of Representatives, § 3158, Congress 13089, H(3) Hearings, pp. 49-50).

Under this definition the operation of the Scotia Bank without sufficient equity capital to support the level of the operations and provide an adequate cushion of protection for the depositors' funds is an un-

safe or unsound banking practice within the meaning of 12 U.S.C. § 1818. The facts found above show that this is the case.

E. The June 1978 Agreement and Subsequent Dealings With The OCC.

The complaint charges, in connection with the inadequacy of respondent bank's equity capital, that it has violated the terms of an agreement effective June 22, 1978, which required the bank to raise $750,000 in new equity capital by November 30, 1978. It is further charged that the bank failed to adhere to a later commitment to raise such new equity capital by May 1979 and that it also failed to comply with a condition imposed upon its paying of a dividend on January 22, 1979, which condition required the bank to raise the $750,000 in new equity capital by June 30, 1979.

In view of the present posture of this case, wherein respondent bank is found to be

in need of $1.5 million in equity capital, such allegations might appear immaterial. However, since these allegations, if true, show a propensity on the part of bank management to disobey its agreements and commitments and, further, since they would constitute independent violations of 12 U.S.C. § 1818 they still merit attention. 11/

Insofar as the June 22, 1978 agreement is concerned, I find that such agreement did not constitute a firm commitment by respondents to raise the $750,000 equity by November 30, 1978. The June 22, 1978 agreement consists of both the letter attached and the document entitled "Agreement By And Between

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11/ 12 U.S.C. § 1818(b)(1) provides, "If . . . the agency has reasonable cause to believe that the bank is about to violate . . . any condition imposed in writing by the agency in connection with the granting of any application or other request by the bank, or any written agreement entered into with the agency, the agency may issue and serve upon the bank a notice of charges in respect thereof."

The First National Bank of Scotia, Scotia, New York and the Office of the Comptroller of the Currency" (RX 1 and CX 2). The record reveals that both parties signed the agreement as thus composed. The letter clearly was intended to modify and explain the terms of the attached agreement and clearly affects its terms, at least with regard to the commitment to raise new equity capital. Counsel for complainant has not rebutted respondents' citations to New York case law respecting the law of contracts and has, in fact, agreed that there can be no contract without a meeting of the minds (CRB, p. 3). Accordingly, either the letter and attached "agreement" constitute the agreement between the Scotia Bank and the Comptroller, or there was no agreement at all.

Respondents' letter of June 20, 1978 (RX 1) begins:

> This letter has been developed to provide additional information necessary for the proper understanding

> of the attached document [the "agreement" -- CX 2].

Insofar as the capital requirements of the "agreement" are concerned, the letter continues on page two to state:

> Article V(7) The Board will develop an analysis of present and future capital needs. As stated in our letter of January 19, 1978, capital must be developed through retained earnings. A successful equity program may be possible in 1980. Your requirements . . . would make any offering of common stock before November 30, 1978 most unattractive to the investment community. However, as requested, we will develop a program (Emphasis added).

Contrary to its usual procedures the regional office of the Comptroller signed such agreement and returned a copy to the bank, keeping the "agreement" and attached covering letter intact. Prior oral comments and later letters by Comptroller's counsel (CX 3) cannot alter the fact. The agreement which was signed consisted of both RX 1 and CX 2. The agreement did not provide a firm commitment

by the bank to raise $750,000 in new equity capital by November 30, 1978.

Consistent with such finding I must also find that the later submissions on July 5, 1978 and October 24, 1978 (CX 4 and 8) did not constitute firm agreements to raise the amounts of new equity capital stated therein.

On the other hand, the record demonstrates that the Comptroller did impose a condition on the bank's paying of a January 1979 dividend, whereby the bank was required to raise $750,000 in new equity capital by June 30, 1978. On January 3, 1979, the bank requested permission of the OCC to pay a dividend (RX 4). On January 22, 1979, the OCC granted permission to pay a dividend of $.15 per share to stockholders as of January 19, 1979 (CX 14). The letter states, among other things:

> Based on the above factors . . . and its commitment to raise $750,000 in equity funds by June 30, 1979, permission is grant-

ed to pay the aforementioned dividend.

It is true that the bank's proposal to raise this amount of new equity funds received a set-back when its Offering Circular was rejected by the Securities Disclosure Division on January 16, 1980. However, it did not act very promptly to correct the deficiencies noted in the detailed comments of that Division in CX 12. Thus, on April 6, 1979, the bank wrote to a Mr. DeLorenzo in the Regional Office of the Comptroller and stated that a revised Offering Circular could not be completed before May 21, 1979 (CX 15). Three weeks later, respondents informed the bank's shareholders that it was doubtful that the capital program would be ready to proceed before the summer (CX 16). Then on May 23, 1979, it was proposed in a letter to the Deputy Regional Administrator that the bank reduce its capital program from $750,000 to $250,000 (CX 18). The OCC did not accept

this proposal, but agreed to review the needs of the bank, insofar as equity capital was concerned, when the Spring 1979 examination was analyzed. However, when the bank was later informed that the $750,000 was no longer enough, it then found that it would be possible to move quickly on the old proposal to raise $750,000 in new equity funds (See RX 16 and 18). This is convincing evidence that respondents were dragging their feet in the Spring of 1979 and had no intention of complying with the condition imposed upon the payment of their January dividend.

Moreover, this entire course of dealing, beginning with the June 1978 agreement, reveals respondents extreme reluctance to raise the substantial amounts of new equity capital required for the safe and sound operation of the bank. Such reluctance also demonstrates that management put personal considerations above the good of the bank. It was evident

that, given the financial condition of the bank and its inability to pay substantial dividends, such a large amount of new equity funds could not be obtained from purchase of minority shares of stock. In order to obtain such capital then, the bank's offering would have to attract new majority shareholders. Consequently, management would have to give up its controlling position in the bank. The evidence shows it was loathe to do so.

However understandable this reluctance may have been, the evidence reveals that it substantially delayed recognition of the bank's genuine need for an injection of new equity funds. Such delay was a violation of the condition imposed on the paying of the January 1979 dividend and was also an unsafe or unsound banking practice within the meaning of 12 U.S.C. § 1818.

III. THE CHIEF EXECUTIVE OFFICER HAS BEEN UNABLE OR UNWILLING TO PROPERLY DIRECT THE AFFAIRS OF THE BANK

All of the above facts indicate that the First National Bank of Scotia has suffered from poor management over the last several years. This fact is further borne out by the account of the dealings surrounding its Erie Boulevard Branch in Schenectady, as detailed below. The evidence herein indicates, at the very least, an unwillingness to properly direct the affairs of the bank in recent years.

However, the record does not overlook the fact that Mr. Kenneth Buhrmaster, the chief executive officer, successfully directed this bank from a small, single-unit bank with assets of $7 million to a multi-branch bank with assets of over $60 million. Although I find his reputation in the banking community to be of little relevance to the issues of this case, his actual record in operating the Scotia Bank certainly bears on

his basic abilities.

The record demonstrates that a number of unwise decisions were made in recent years and that the bank's management was reluctant to take steps to correct its mistakes. It also reveals that there were substantial economic changes in this market which exacerbated the consequences of such mismanagement. While the economic changes do not excuse management's actions, they do have some bearing on the order provisions proposed by complaint counsel, as will be more fully noted below.

In any event the conduct of the bank's chief executive officer in failing to cooperate fully with the OCC to restore the bank to a safe and sound condition demonstrates an unwillingness to direct the affairs of the bank in accordance with safe and sound banking practices, applicable laws, rules and regulations and constitutes an unsafe or unsound banking practice as charged in the

Notice of Charges.

IV. THE ERIE BOULEVARD BRANCH TRANSACTION

A. The Bank Invested in the Erie Boulevard Branch in Violation of 12 U.S.C. § 371(d)

Sometime prior to April 1974, the bank's management decided to open a branch in Schenectady, New York, at a site on Erie Boulevard in that city. At the time the bank did not have sufficient equity capital to invest in such a branch without violating the provisions of 12 U.S.C. § 371(d). The latter statute provides:

> No national bank, without the approval of the Comptroller of the Currency, and no State member bank, without the approval of the Board of Governors of the Federal Reserve System, shall (1) invest in bank premises, or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such bank, or (2) make loans to or upon the security of the stock of any such corporation, if the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by such corporation, which

> is an affiliate of the bank, as defined in section 221a of this title, will exceed the amount of the capital stock of such bank.

In order to avoid the restrictions of this law, bank management (the Buhrmasters) decided to seek out an enterpreneur who would erect the branch building for them and lease it to the bank, with an option to purchase when the bank's capital stock would allow. Up to this point, there was no apparent conflict with the statute. However, the Buhrmasters decided after seeking out such entrepreneurs that the cost to the bank, over time, was going to be prohibitive and beyond its means. They then decided to take on the job themselves, through their family-owned oil business, the J. H. Buhrmaster Co. (hereinafter JHB Co.).

The land on which the Branch bank was to be built had already been acquired by the Buhrmasters, either directly in the name of

the JHB Co. or through the Sanrit Realty Corporation (hereinafter Sanrit Corp.), a realty company whose stock was purchased by JHB Co. in 1972 (CX 24). Such land consisted of three parcels of land on Erie Boulevard in Schenectady - Parcels A, B and C (See Appendix I, attached).

JHB Co. and the bank entered into an agreement, dated April 11, 1974 (CX 26A-K). The purpose of the agreement, as stated therein, was the development of a branch banking facility on the Erie Boulevard properties. JHB Co.'s role in this transaction was ostensibly that of owner and lessor of the premises. 12/

The transaction, however, was not an ordinary leasing transaction. JHB Co. invested no money in the transaction and did not ex-

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12/ The agreement called for the execution of a lease on the "closing date" (CX 26, Section 3.3). However, such a lease was never made. The "closing date" set by the agreement was March 11, 1975 (CX 26, Section 3.2).

pect to profit materially from it. Moreover, it was explicitly understood and provided that the JHB Co. would suffer no harm "in any way by helping out the First National Bank of Scotia." (Emphasis added) (J. Buhrmaster, Tr. 392). There was to be no expense on the part of such company under the agreement, not even to the extent of showing any loss through the depreciation of the branch property on its books (CX 26, Section 3.3). It was also provided that the bank was to pay for all expenses related to the branch, in lieu of a fixed rental (CX 26, Section 3.3) 13/ and that the bank would have the option to purchase the "leased premises" at cost, at any time during the original term of the lease

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13/ In the absence of a formal lease agreement these expenses were liberally interpreted by bank management (the Buhrmasters) and JHB Co. (the Buhrmasters) on somewhat less than an arms-length basis. (See the description of the easement payments to the Sanrit Corp., below).

and any renewals (CX 26, Section 3.3). 14/ Furthermore, in view of the fact that JHB Co. was only able to finance $2 million of the $2.5 million cost of the branch facility, the bank, not JHB Co., paid the additional $500,000 required to develop the project.

In light of these facts, it must be concluded that the real investor in the Erie Boulevard Branch facility was the bank, not JHB Co. JHB Co. merely served as the bank's alter ego throughout the transaction. The law would not allow the bank to invest, so it set up a sham transaction with JHB Co. whereby it accomplished its purpose. This is a violation of 12 U.S.C. § 371(d). The ultimate results of such transaction, moreover, have dramatically proven the wisdom of the

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14/ Since the bank was paying all the costs associated with ownership, exercise of the purchase option essentially involved only the transfer of title, at such time as the bank's capital stock would allow under 12 U.S.C. § 371(d).

statute, since the record shows this branch has played a very significant part in creating the bank's present capital predicament.

B. The Buhrmasters Disguised The Bank's Illegal Investment.

In order to disguise the fact that the bank had illegally invested in the Erie Boulevard Branch, the Buhrmasters engaged in a number of deceptive practices. The first and most obvious of these was putting the title and finance papers in the name of JHB Co. The next was the creation of a Development Agreement (CX 28) and Lease Agreement (CX 29) both dated January 9, 1975, which the bank thereafter held out as the true arrangement between the parties.

CX 28 and 29, the January 9, 1975 agreement and lease, differ radically from the April 11, 1974 agreement. They require the bank to pay only a flat rental, the purpose

of which is to amortize the construction loan, and they do not require the payment of numerous additional items specified in the 1974 document (which payments the bank is actually paying). Second, they give the bank the option to buy at fair market value rather than cost.

CX 28 and 29, the January 1975 agreement and lease were both executed and then ratified and confirmed by the Board of Directors. Notwithstanding the fact there were some blanks left in such documents, they were then held out as the true agreement and were the only documents kept on file at the bank to evidence the basis for the Erie Boulevard Branch arrangement.

As further evidence of this deception, such documents were delivered to the Schenectady Savings Bank, which financed construction of the Branch, in response to that

bank's requirement for a lease between JHB Co. and the Scotia Bank.

Moreover, in response to a provision of the June 22, 1978 agreement with OCC, the bank was required to have an independent appraisal of the reasonableness of the lease on the Schenectady Branch. 15/ Such an appraisal was obtained and submitted to the Acting Regional Administrator of the Second National Bank Region by cover letter dated September 13, 1978 (CX 36E). Page 7 of the appraiser's report shows that the 1975 agreement and lease were submitted to the appraiser, and thus ultimately to the OCC, as the controlling documents in its Erie Boulevard expenditures (CX 36-0).

Furthermore, the April 1974 agreement, although the true controlling document, was

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15/ The cover letter (RX 1) did not alter the terms of this provision of the agreement, but merely noted that such provision was a very costly requirement.

not revealed to the Schenectady Savings Bank, the OCC, or the bank examiners. 16/ This was undoubtedly the result of the Buhrmasters' recognition of the fact that such agreement revealed the true nature of the arrangement, i.e., that the bank was the real investor in the Branch. This assessment of the evidence is supported by a note from Louis Buhrmaster to the bank's attorney dated 4/1/74 which

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16/ I simply cannot credit Louis Buhrmaster's testimony about his communications with the bank examiners concerning the 1975 lease. He admits that he spent a long time with the assistant examiner "trying to reconcile the figures in the agreement, so-called agreement dated January 9, 1975. . . ." (Tr. 464). He could not recall telling either Mr. Farrell, or his assistant, that the January 1975 documents were only "for instance" documents (Tr. 736-37). Since he certainly knew the 1975 agreement was not the true agreement, the hours spent at trying to reconcile it can only be considered a charade. It is also simply too convenient to blame the sloppy work habits of the deceased Mr. Hoppe for the fact that a copy of the 1974 agreement was not readily available in the bank's files (Tr. 736-37).

states in part:

> This brings another point to mind, in all of the leases I have read the lease calls for the sale of the building by the lessor to the lessee at "fair market value." In checking with T. M. Byxbee Co. [the bank's auditing company] this must be in to make it a valid lease or it would have to be capitalized on the banks book -- which I believe is illegal based on our capital now. As far as we are concerned whenever the bank can take the Co. out clean we will be happy (Emphasis added) (CX 27A).

Respondents' deception was part and parcel of their violation of 12 U.S.C. § 371(d) and is in itself an unsafe or unsound banking practice within the meaning of 12 U.S.C. § 1818.

C. The Bank's Payment of $50,000 per Annum as Compensation for the Depreciation of the Branch Property Was An Unsafe or Unsound Banking Practice.

It is not diputed that depreciation expenses were paid by the Bank in accordance with the terms of the 1974 agreement (CX 26).

The Bank's payment of $50,000 per annum was designed to offset the depreciation of the branch property and to ensure that JHB did not show a loss, even a book-loss, as a result of the branch transaction. However, because the $50,000 depreciation is not a cash expenditure on the part of JHB Co. but merely a debit entry for accounting and tax purposes, the Bank's payment of the depreciation expense results in a financial benefit to JHB Co. On its income statements, the profit to JHB Co. over a thirty-year term will amount to $2,000,000 -- the initial value of the branch property (CX 31; Ward 65-69).

It is not unusual in a true leasing agreement for the lessor to receive a profit under the lease; the fact that JHB Co. has profited from the branch transaction is not in and of itself a violation of sound banking practices; nor does it indicate that the

1974 agreement was an unconscionable contract.

However, that agreement was not a true leasing agreement and was in violation of 12 U.S.C. § 371(d). As previously found, the acquisition of the Branch under the guise of a rental agreement violated that statute because the terms of the 1974 agreement were not those of a lease but those of a sales contract. The under capitalization of the Bank, which constitutes the underlying reason for the § 371(d) violation, is certainly aggravated by the occupancy expense for the branch bank, a sizeable portion of which is attributable to the $50,000 per annum depreciation expense.

D. The Bank Has Paid Taxes On Land Owned by Sanrit Corp. And Paid for Easement Rights On Such Land Neither Of Which It Was Obligated To Pay.

Section 3.3(a) of the 1974 agreement provides that the Bank will pay a monthly

rental in the amount of the mortgage payment and

> all payments required to be made to Sanrit Realty Corporation by the Developer in connection with the acquisition of the Sanrit property, leases and easements. An annual rental in the amount of any taxes, . . . paid by the Developer and not reimbursed by the Bank prior to the end of the year. . . . (CX 26D).

This provision has been interpreted by the bank and JHB Co. to require the bank's payment of taxes on Parcels A, B and C shown on CX 24 (Appendix I), despite the fact that the bank is located solely on Parcels A and B and exercises easement rights over only two relatively small portions of Parcel C. It is also interpreted as requiring the bank to pay $100 per month to Sanrit Corp. for easement rights. Neither the payment of taxes on Parcel C, nor the $100 per month payment can be justified by the various underlying agreements in this matter. Those agreements consist of the April 1974 agreement between the

bank and JHB Co. and January 9, 1975 agreement between Sanrit Corp. and JHB Co.

As a background to such agreements, it is important to note that Sanrit Corp. is a wholly-owned subsidiary of JHB Co. As noted above, JHB Co. acquired the stock of Sanrit Corp. in 1972. Therefore, we are not concerned here with an arms-length transaction between three separate corporate entities, but, in fact, with the Buhrmasters as majority stockholders of the bank, JHB Co. and Sanrit Corp.

There is nothing in the Sanrit-JHB Co. agreement which requires JHB Co. to pay taxes on Parcel C. It is, pure and simple, an easement agreement. Of course since Sanrit Corp. is a subsidiary of JHB Co., JHB Co. does pay the taxes on Parcel C. This fact, however, does not create any obligation on the part of the bank, insofar as Parcel C is concerned. The only reference to Sanrit in

the April 11, 1974 agreement between the bank and JHB Co. includes "all payments required to be made to Sanrit Realty Corporation by the developer [JHB Co.] in connection with the acquisition of the Sanrit property, leases and easements." As for taxes, the 1974 agrement only indicates that the bank should pay taxes on the branch premises (CX 26D).

Nor can I credit the testimony of Louis Buhrmaster that the entire Parcel C was a part of the bank's premises. The only support Mr. Buhrmaster could muster for his testimony was the statement that all of Parcel C was used during snow removal procedures and that fill sand was taken from it during construction. Such usage would not justify the Buhrmaster's interpretation of the April 1974 agreement as requiring the payment of taxes on such parcel.

In view of these facts it must be found that the bank has unlawfully paid approximately $8,000 in taxes on Parcel C without obligation or justification. Such practice is an unsafe or unsound banking practice within the meaning of 12 U.S.C. § 1818, particularly in view of the bank's unsound capital condition during this time period.

Furthermore, the bank has, at the same time, paid $100 per month for easement rights over two small portions of this property (Parcel C). The portions are indicated by the shaded areas o Appendix I hereto, and consist of a small arc in the lower right-hand corner of Parcel C and the thin strip of land to the rear of Parcel A, between it and the Penn Central right-of-way. The first of such easements, the small arc has been described as extending slightly further than the 25 feet shown on Appendix I. In any event, the two portions of Parcel C, put together, rep-

resent only a small part of Parcel C.

As to the bank's obligation to pay Sanrit Corp. for easement rights, such obligation, if any, would arise from the same two documents -- CX 26 and 35. The April 1974 agreement does require, as noted above, all payments required to be paid to Sanrit Corp. in connection with easements (CX 26D). The agreement between Sanrit Corp. and JHB Co. then provides for such easements (CX 35). The latter document, however, provides that the consideration for such easements is " . . . One and 00/100 ($1.00) Dollar, and other valuable consideration, the receipt and sufficiency of which is hereby acknowledged. . . . " (CX 35A). Nothing in such agreement justifies a payment of $100 per month for such easements. Again, Mr. Louis Buhrmaster's allegation that the entire Parce C is used during snow removal procedures and that fill dirt was taken from that parcel

during construction cannot justify such expenditures.

Therefore, such payments were also unjustified and constituted and now constitute further unsafe or unsound banking practices by respondents within the meaning of 12 U.S.C. § 1818.

V. THE BUHRMASTERS HAVE MISUSED THE ASSETS OF THE BANK

In view of the dealings between the bank, Kenneth E. Buhrmaster, Louis H. Buhrmaster, JHB Co. and related Buhrmaster family interests, surrounding the bank's investment in the Erie Boulevard Branch facility, it is found that the Buhrmasters and their family enterprises have misused the assets of the bank by causing the bank to enter into transactions with them on less than an arms-length basis to the detriment of the bank. A simple illustration of this fact is their failure to

enter into a formal lease agreement, in contravention of their April 1974 agreement, and their subsequent liberal interpretation of the latter agreement in connection with the payments to the Sanrit Corp. (their own alter-ego) and the payment of taxes on the Sanrit parcel. Such practices are an unsafe or unsound banking practice within the meaning of 12 U.S.C. § 1818.

VI. THE BANK HAS ACCUMULATED AN EXCESSIVE NUMBER OF POOR QUALITY ASSETS

Contrary to safe and sound banking practices, the Scotia Bank has accumulated an excessively large volume of poor quality assets. As stated in Section I.A, supra, the volume of such assets is in excess of the bank's gross capital funds.

The accumulation of such a large volume of criticized assets is primarily the result of imprudent, unsafe and unsound lending

practices. Specifically, the bank has made numerous loans with an overreliance on underlying collateral values (primarily in the form of real estate), and without sufficient review and proof of the borrower's ability to repay the loan in the normal course of business. The bank has also made it a practice to unduly rely on the borrowers' illiquid net worths (CX 1JJ-WW). Such practices have led to numerous problem loan situations and have resulted in protracted periods of collection as well as cumbersome foreclosure actions on some loans. This in turn has led to the large volume of loan losses respondent bank has incurred and its large accumulation of "other real estate owned" (CX 1X-L, 48).

Another indication of this bank's unsafe and unsound handling of its loan accounts is the volume of its credit exceptions. The volume of the bank's credit exceptions and lack of current and satisfactory credit in-

formation more than doubled between the 1979 examination and the prior examinations in 1978 (CX 1B). This is despite the fact that such problems had been addressed in the June 22, 1978 agreement. 17/ Mr. Farrell, the examiner in charge of the 1979 examination could recall only a "few instances" in his experience where the credit files of other banks were as bad as those he found at the Scotia Bank (Tr. 145).

Respondents attempted to dispute the level of criticized assets by introducing evidence to show that the examiner's information was incorrect as to a number of loans

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17/ Although the agreement (CX 2), on its face, required respondents to submit to the Regional Administrator, within days, a "written program to improve its credit files and to eliminate all assets from criticized status," the covering letter (RX 1) abrogated such requirement. As I noted above, the covering letter must be read as part of a agreement. As a result, respondents' failure to submit a plan in this regard within 30 days of the June 1978 agreement is not a separate violation.

(La Violette, Tr. 741-764; RX 43). As noted in footnote 2, supra, I agree that the discount portion of the installment loans should be deducted. 18/ However, such deduction still leaves the volume of classified assets at over 100% of gross capital funds. More-

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18/ The inclusion of the $119,000 discount in the installment an figures was not an error on the part of the examiner. He was simply following accepted OCC procedures. It would take an inordinate length of time to determine the amount of such discount and it does now substantially distort the picture obtained by the examination. On the other hand, there a certain amount of unfairness to the bank from its conclusion. The only error I find on the part of the examiner was his failure to determine the effect of the bank's liens motor vehicles in the Fuellhart Line (CX 1 JJ). However, such error did not affect the volume of classified loans. The only change this would affect would be to move $22,000 from one classification (substandard) to another (OAEM). As to respondents' contentions concerning other criticized assets, there appears to be some basis for including each of such assets in a classified status (See La Violette, Tr. 741-764). The arguments of respondents as to the classification these latter assets appear to be based on their misapprehension as to the criteria for classification of loans (Compare: La Violette, Tr. 766-768; Vaez, Tr. 840-842).

over, if the total of the additional criticized assets contested by respondents (approximately $670,000) were added to the $119,699 discount figure and deducted from the total of criticized assets, the volume of criticized assets would still be unacceptable. The resulting percentage of classified assets to gross capital funds would still be in excess of 80% and would still be considered unsafe or unsound, within the meaning of 12 U.S.C. § 1818.

VII. THE BANK HAS OPERATED WITHOUT AN ADEQUATE ALLOWANCE FOR POSSIBLE LOAN LOSSES.

From approximately June 1978 until August 1979 respondent bank maintained its Allowance For Possible Loan Losses (APLL) at approximately .75% of its total loans. 19/

19/ APLL consists of a segregated portion of the bank's capital which is set aside to absorb the loan losses which may be sustained by the bank.

In August 1979, due to the insistence of OCC, the APLL was raised to over 1% of total loans.

Prior to August 1979, the bank's APLL was inadequate. The bank had failed to recognize the poor quality of many of its loans and make adequate provision for them. There was not enough in this account to cover the total accounts classified as "loss" by the examiner. In fact, there was a shortfall in this regard of $68,000. In order to raise the APLL to an adequate level the OCC required an immediate injection of $393,000. The failure to recognize the need for additional coverage in the APLL account, especially in light of the bank's inadequate capital structure, was an unsafe or unsound banking practice within the meaning of 12 U.S.C. § 1818.

The Notice of Charges further alleges that this violation has been aggravated "by

the fact that quarterly reviews the Board of Directors [of the bank] conducted of the Allowance For Possible Loan Losses, as required by Article VII, paragraph 10, of the [June 1978] AGREEMENT, have been inadequate and have not been properly documented." The June 1978 agreement merely requires the bank to make quarterly reviews of the APLL and adjust it in accordance with the findings of the review, or "as indicated by the Regional Administrator." This part of the agreement was not abrogated by the covering letter, and it would seem that respondents' literally complied with such provisions. The agreement does not specify that any certain type of documentation accompany the quarterly reports and there appears to be no question that the quarterly reviews and reports were made. The facts that such reviews turned out to be inadequate and that the OCC had to order the injection of additional funds into this ac-

count in August 1979 do not constitute a separate violation from, or an aggravation of, the violation found just above.

The quality of the bank's review of APLL, however, does illustrate the unsafe and unsound nature of its management decisions in this regard. It is clear from the actions of the bank that it fails to understand either the purpose or the importance of the APLL. The blind adherance to an APLL of .75% of total loans, despite the rapid deterioration of the loan portfolio (CX 1B), and an increasing rate of delinquent loans (CX 48), certainly demonstrates such lack of understanding.

VIII. THE BANK HAS FAILED TO DEVELOP ADEQUATE INTERNAL CONTROLS AND AUDITING PROCEDURES

As of the last examination the Scotia Bank had contrary to safe and sound banking practices, failed to develop adequate internal controls and auditing procedures. The

number of such deficiencies found by the examiner was voluminous (CX 1 UUU-XXX). Some of the exceptions were quite serious involving lack of dual controls. Other exceptions show that the bank has failed to develop adequate internal and external auditing procedures. Neither its internal auditing procedures, nor the external audit conducted by T.R.M. Byxbee Co. constitute proper bank audits. In addition, despite the fact that it is recommended that banks with total assets of $25 million or more have a full-time internal auditor, this bank with assets in excess of $50 million has none. Due to the poor quality of respondent bank's assets and its deteriorating condition, which has been greatly aggravated by poor management decisions, these deficiencies constitute unsafe or unsound banking practices within the meaning of 12 U.S.C. § 1818.

IX. THE BANK'S PROGRAMS TO REDUCE RELIANCE ON RATE-SENSITIVE FUNDS, IMPROVE EARNINGS, AND REDUCE OCCUPANCY AND PERSONNEL EXPENSES.

A. Reliance On Rate-Sensitive Funds.

Complainant admits that respondent bank has reduced its reliance on rate-sensitive funds over the past several years (CF, p. 36). It is contended, however, that the bank's actions are insufficient and that the present level of reliance on rate-sensitive funds still constitutes an unsafe or unsound banking practice.

Between December 31, 1978 and December 31, 1979, respondent bank reduced its dependence on rate-sensitive funds by almost one-half. As of December 31, 1978, the disparity between its rate-sensitive liabilities and its rate-sensitive assets was in excess of $10 million, by December 31, 1979, this was reduced to $5.453 million (CX 22Q).

However, the disparity between rate-sensitive liabilities and rate-sensitive as-

sets is still unacceptably high. This disparity continues to expose the bank to a high degres of risk due to interest rate exposure. 20/ Given the bank's capital inadequacy, its poor earnings, its heavy occupancy expense and the quality of its assets at this time, such a high rate of exposure is an unsafe and unsound banking practice within the meaning of 12 U.S.C. § 1818. 21/

20/ As noted in Section I.A, above, the use of rate-sensitive liabilities to fund other than rate-sensitive assets creates two risks: (1) a liquidity risk; and (2) an interest rate risk. During the period following the examination respondents remedied the liquidity problems, but not the interest rate risk.

21/ Respondents' reliance on RX 38 to rebut complainant's case with regard to rate-sensitive liability/assets exposure is misplaced. This exhibit does not accurately depict the bank's volume of rate-sensitive funds, since it omits all money market certificates. The volume of such funds is substantial (CX 82-I). Further the disparity between rate-sensitive assets and rate-sensitive deposits is distorted in RX 38 due to the inclusion of "loan paybacks." Although such figures have a bearing on the "liquidity" problem attendant in such disparity, they do not affect the bank's interest rate exposure.

The Notice of Charges also alleges that this violation has been aggravated by respondent's failure to implement a program to reduce its reliance on rate-sensitive funds and borrowed funds, as required by the June 1978 agreement. Complainant points out that respondents did not submit a plan within 30 days of that agreement, as required, and, in fact, did not submit any proposal in this regard until November 23, 1979. It is further alleged that the latter plan was defective.

Upon reviewing CX 2 and RX 1, the June 1978 agreement and covering letter, I find that respondents did agree to submit a plan within the said 30-day period. Although the covering letter indicates that respondents felt that the bank's reliance on rate-sensitive funds could only be cured over a considerable period of time, there is no indication that they would not submit the plan required by CX 2. Therefore, the submission of a

simple status report (CX 63) within the stated time period was a violation of the agreement. This violation was aggravated by the fact that the bank did not submit any plan thereafter, until November 23, 1979, and that the latter plan still failed to set forth how the bank was going to reduce its reliance on rate-sensitive funds. Such actions are an indication of respondents' failure to grasp the seriousness of the bank's situation and were an aggravation of the unsafe or unsound banking practices with respect to the bank's reliance on rate-sensitive funds.

B. Failure to Develop a Program to Improve Earnings.

The Scotia Bank's net earnings, before the payment of dividends, have declined precipitously over the past three years (CX 22N). These poor, and ultimately non-exis-

tent earnings have partially depleted the bank's equity capital and resulted in a negative undivided profits account of $381,000 (CX 22D). In spite of this the bank has failed to develop an appropriate program to improve its earnings.

On July 17, 1978, the bank submitted a plan to improve its earnings by the implementation of ten specific proposals (CX 67). In a follow-up letter of October 30, 1978, it reported progress on some of these proposals (CX 69). Its basic plan was accepted, with some reservations, by the OCC by letter dated February 9, 1979 (CX 72). However, a number of the ten proposals were either not satisfactorily implemented or were of inconsequential value. As a result, the bank's earnings continued to decline.

The first of these ineffective proposals was: "Do not hire additional officer to replace Vice President and Cashier R.B. Hoppe,

who passed away on June 13, 1978. Net savings: $20,000 per year" (CX 67B). This savings figure was corrected, during the testimony of Louis Buhrmaster, to $30,000 per year and it was alleged that there was an additional saving of $15,000 realized from the failure to replace another officer, Randall Reed, Director of Computer Operations (Tr. 738). Although such savings would have been meaningful, they were almost completely offset by a concomitant increase in the salaries of several officers by a total of $39,000 per year. A major portion of this $39,000 (38%) went to respondents Kenneth and Louis Buhrmaster. In view of the fact that the bank was then losing about $19,000 per month in operations, such salary increases were of doubtful wisdom; especially since the quality of bank management at that time was poor, as seen by the facts related above. In any event, such salary increases all but negated

the effect of this savings as proposed by bank management in their July 1978 plan.

The next proposal of doubtful value was the bank's plan to save $1,000 per year through reduced lighting expenses. Since the bank's earnings in 1979 came to a minus $491,000, such proposal was not really meaningful.

The third proposal which is subject to criticism is its plan to adjust the bank's depreciation schedule. Since the depreciation expense is not a cash item, but merely a book entry for accounting and tax purposes, an adjustment of this expense schedule cannot improve the bank's earnings.

The fourth item proposed in the July 1978 plan which complainant takes issue with, is the bank's attempt to lease the remaining vacant space in the basement of the Erie Boulevard Branch. It has been almost two years since this plan was proposed and such space

still has not been leased as of the time of the hearing.

The last savings proposed in the July 1978 plan was an attempt to have taxes lowered on the Erie Boulevard Branch. The proposal itself indicates that it could not have any immediate practical effect and the testimony of Louis Buhrmaster indicates such relief would depend on future legal action (Tr. 644). Therefore, this portion of the proposal was not of much practical assistance in alleviating the bank's earning problems.

Nor did bank management even take the most obvious step to reduce the bank's expenditures by eliminating the unlawful payments it was making to and for the Sanrit Corp. Although such payments may not have been very substantial, they were at least more noteworthy than the proposed $1,000 to be saved from reduced lighting.

The fact that the Bank's earnings have

continued to decline so steeply is the best indication of the ineffectiveness of the bank's actions and the inefficacy of its July 1978 plan. The plan quite clearly did not meet the bank's needs. The failure to adopt an appropriate plan to increase the bank's earnings, in view of its deteriorating condition and the warnings it received from the OCC, must be considered an unsafe or unsound banking practice.

Moreover, this violation was aggravated by the fact that the bank failed to fully implement the plan which it submitted in July 1978, in violation of its agreement of June 22, 1978 (Article VI, paragraph 8). For example, the failure to retain the full savings, or at least a substantial part thereof, from the elimination of the positions of Mr. Hoppe and Mr. Reed was in direct contravention of the bank's plan.

C. Failure to Reduce the Bank's Occupancy and Personnel Expenses.

A substantial part of the bank's poor performance has been its high occupancy and personnel expenses. As for the occupancy expense, the ratio of this expense to average assets for the Scotia Bank has doubled since 1974 from .71% to 1.41% (CX 22R). Its personnel expenses have also increased during this time period, as a percentage of average assets, from 1.66% to 2.15% (CX 22R). Respondents have taken some significant steps to reduce personnel expenses since 1978, but there have been no steps taken to reduce occupancy expenses.

CX 22R shows that there was a reduction of $2,000 in personnel expenses between 1978 and 1979. In these inflationary times, even that might be considered an important improvement. However, Louis Buhrmaster testified that this exhibit was deceptive since

there was an extra pay period in 1979 (Tr. 719-721). With the exception of the officers, all bank personnel are paid on a bi-weekly basis (Tr. 724-725); Mr. Buhrmaster estimated that the payroll expense entailed in an extra pay period would be between $40,000 and $50,000 (Tr. 720). Therefore, the savings on CX 22R are understated by approximately $40,000 to $50,000. 22/

A reduction of $40,000 to $50,000 in personnel expenses must be viewed as significant. With so little else in this record to commend the management of this bank, such

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22/ Counsel for complainant have offered no rebuttal to this testimony. They simply argue, on brief, that the only differences between 1978 and 1979 was that the former started on a Sunday and the latter on a Monday and that "This could hardly cause a difference in the number of pay periods" (CF, p. 41). However, all one has to do to see that this is a specious argument is to look at the pay calendar for federal employees. I will take official notice of the well-known fact that such pay periods do not always begin on January 1, nor end on December 31 and that there are years when there is an extra two-week pay period.

progress cannot be ignored or belittled. At the same time, though, it must be recognized that during this same time period the officers of the bank were granted a $39,000 raise and that 38% of this amount went to Kenneth and Louis Buhrmaster. In view of the many deficiencies noted in this record such increases must be considered an unsafe or unsound banking practice.

On the occupancy expense side there is no bright side to the picture. As noted above, such expense has doubled, as a percentage of average assets, since 1974. In fact, during this time period, the occupancy expense has almost doubled numerically from $428,000 in 1974 to $818,000 in 1979. 23/

23/ RX 39, which purportedly shows a slight decrease in occupancy expense between 1978 and 1979 cannot be credited, since it compares expenses between the first half of 1978 and the last half of 1979 and the two periods have not been shown to be comparable. This is especially so where the bank's own financial reports (CX 81C and 82G) contradict such exhibit.

This experience has been due in great part to the unlawful investment in the Erie Boulevard Branch, as described above.

The bank's failure to take any steps to reduce the burden of these escalating occupancy expenses is an unsafe or unsound banking practice within the meaning of 12 U.S.C. § 1818.

It is also charged that the bank has failed to develop acceptable programs to reduce its occupancy and personnel expenses, and that such failure has aggravated the unsafe or unsound practices of the bank in these respects. 24/ As for personnel expenses, I find that the bank did initiate an appropriate plan to reduce these expenses through the elimination of certain positions. On the other hand, respondents failed to

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24/ Article VI, paragraph 8 of the June 1978 agreement (CX 2) requires that such programs be formulated. The covering letter (RX 1) does not abrogate such provisions.

fully implement this plan, especially with regard to the raises granted to Kenneth and Louis Buhrmaster.

As for occupancy expenses, the July 1978 plan submitted by the bank had only three substantive provisions aimed at such expenses. They were: the reduction of lighting expense by $1,000; the attempt to lease remaining vacant space in the basement of the Erie Boulevard Branch for $6,000; and the attempt to have the taxes lowered on the Erie Boulevard office (CX 67B and C). The lighting expense savings must be considered inconsequential, in view of the almost $400,000 increase in occupancy expense since 1974. Neither of the other two savings have been realized, even if they might be of some substance. The July 1978 plan must be considered inadequate and the bank's unsafe or unsound practices in maintaining excessively high occupancy expenses must be considered as

aggravated by its failure to develop and implement an appropriate plan to reduce occupany expenses. Furthermore, this failure to develop and implement an appropriate plan is in violation of the formal written agreement between the bank and the OCC (CX 2 and RX 1).

D. The Bank's Occupancy And Personnel Expenses As Compared To Its Peer Group

The complaint charges that the Scotia Bank's occupancy and personnel expenses are excessive as compared to its NBSS "peer group." As noted above, this "peer group" consists of 260 national banks and other federal reserve member banks having assets between $40 and $100 million, with 2 or more full service branches and located in an area considered to be a high density population area (SMSA).

Experts called by respondents contest the accuracy of comparisons between this

"peer group" and the Scotia Bank for a number of reasons, including differences in personnel and occupancy expenses in different areas of the nation. They cite particularly to the high personnel and occupancy expenses in New York State. Insofar as these two expenses are concerned, respondents' experts have made some valid points. The use of the MBSS data would seem to be somewhat impaired, as to these two points of comparison, since they do not make allowance for different wage and occupancy cost experiences in market areas having substantial differences in these regards. However, other evidence of record still reveals that respondent bank's personnel and occupancy expenses are excessive.

Respondents own exhibit CX 54 shows that its personnel expenses were higher than two-thirds of all commercial banks in New York with assets between $25 to $100 million and having five or more branches. Further, CX 85

compares the Scotia Bank's personnel expenses with 15 other national banks in the state of New York having assets between $40 and $80 million. This latter exhibit shows respondent bank as ranking 14th highest out of the 16. It was also pointed out by complainant's expert, Mr. Vaez, that none of the other New York branches exhibited the same degree of problems as was found in the Scotia Bank.

As to occupancy expenses, respondents did not even attempt to introduce an exhibit comparing the Scotia Bank's occupancy costs with a more localized peer group of banks. However, complaint counsel did produce such a comparison between respondent bank and 15 other national banks in New York state having assets between $40 and $80 million. This exhibit (CX 85) shows that the Scotia Bank had the very highest occupancy expense of all such banks. In fact, its ratio of occupancy expense as a percent of average assets was

almost three times that of the "peer" mean in this group. Therefore, there can be no doubt that the respondent bank's occupancy expense is excessive.

X. THE BANK'S FAILURE TO COMPLY WITH CERTAIN RULES AND REGULATIONS

Respondents do not deny having been in violation of the provisions of 12 C.F.R. § 1.8, 12 C.F.R. § 7.3025 and 31 C.F.R. § 103.33(a). Their only defense is that all such violations were corrected either during the course of, or after, the 1979 examination. The fact of discontinuance does not obviate the need for an order in connection with such admitted violations. The record shows that the bank violated 12 C.F.R. § 1.8, by failing to maintain sufficient credit information in its files to demonstrate that it had exercised prudence in purchasing securities, with respect to fifteen separate secur-

ity issuances (CX 75). The bank also violated four separate subsections of 12 C.F.R. § 7.3025 dealing with "Other Real Estate Owned," on numerous occasions (CX 1 H, I, CCC-EEE, HHH-LLL). In connection with 31 C.F.R. § 103.33(a) the bank made loans of over $5,000 not secured by real estate on several occasions without obtaining a statement of the nature or purpose of the loan (CX 1J, NNN000).

In view of the fact that such violations were substantial and were not discontinued until brought to the bank's attention by the examiner, the entrance of an order to cease and desist with respect to such practices is appropriate. Clinton Watch Co. v. Federal Trade Commission, 291 F.2d 838, 841 (7th Cir., 1961); Benrus Watch Co. v. Federal Trade Commission, 353 F.2d 313, 322 (8th Cir., 1965).

XI. THE ORDER PROVISIONS

The proposed findings of complainant includes a proposed order designed to correct the deficiencies alleged in the Notice of Charges and prevent similar unsafe or unsound banking practices in the future. Respondents have not taken issue with the specific provisions of such proposed order in their reply brief, except to the extent that they disagree with the underlying proposed findings of complaint counsel upon which such proposed order is based.

I find that, in the main, the provisions of the proposed order are merely designed to meet the specific violations found and to restore the First National Bank of Scotia to a safe and sound operating basis. Therefore, with only a few exceptions, I have adopted such proposed order in my recommended order attached hereto. The only area in which I believe the proposed order is inappropriate

is in the provision for the employment of a new chief executive officer. I find that such provision is punitive rather than curative. Moreoever, it appears to be both unnecessary and excessively expensive in view of other provisions of the order.

As I noted above in Section II, the record does not reveal the absolute incompetence of Kenneth Buhrmaster to operate this bank. His past history of operations would show a substantial degree of efficiency, despite the evidence of mismanagement over the last several years. It would seem that Mr. Buhrmaster's attentions may possibly have been diverted to other matters during recent years.

In any event his replacement by a new executive, from outside the bank's staff, at this time would seem to be unnecessarily ex-

pensive and counterproductive. 25/ Mr. Vaez admitted that a major asset of the bank, in its present condition, is the high esteem with which the Buhrmaster name is held in the community. To eliminate that asset prematurely while the bank is seeking solutions to its problems would seem unwise. This is especially so where, as here, the rest of the terms of the order are so restrictive as to give the chief executive officer of the bank little real substantive authority. The order effectively places control of the day-to-day affairs of the bank in the Regional Administrator, the Board of Directors and the Compliance Committee. Further, other provisions of the order would force the sale or merger of the bank, if corrective measures have not

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25/ It is quite unlikely that a qualified individual from outside the Scotia Bank would accept the position of Chief Executive Officer, under the other terms of the proposed order, except at a salary much above that presently enjoyed by Mr. Buhrmaster.

been implemented within a relatively short time. Accordingly, the provision requiring the employment of a new chief executive order is not adopted in my recommended order.

I have also made four other minor changes in the provisions of complaint counsel's proposed order. The first provides specific time frames within which the bank must submit proposals for sale or merger, in the event it cannot devise or implement an acceptable program to raise the needed equity capital. This was not provided in the original proposed order since Article I thereof did not specify any time frame within which the subject activity must be completed. The second change was to eliminate the provision that a sale of the Erie Boulevard Branch must be "to an independent outside party." So long as the bank is made whole and does not retain any interest, it should not matter to the Comptroller if the branch building and

property are sold to the Buhrmasters, for instance, or any other party. The third change is that I have extended the period within which respondents must correct the violation of 12 U.S.C. § 371(d) to one hundred and eighty (180) days. In the event the Branch must be sold even this is a very short time, considering the specialized nature of the property. The final change is that I have added a new provision (Article XIII) with respect to the bank's violation of 12 C.F.R. § 1.8, 12 C.F.R. § 7.3025 and 31 C.F.R. § 103.33(a).

XIII. CONCLUSIONS

1. The Office of the Comptroller of the Currency has jurisdiction over the subject matter of this proceeding and the respondents.

2. The Notice of Charges herein states a cause of action and the proceeding is in

the public interest.

3. The aforesaid acts and practices of the respondents as found in the foregoing Findings of Fact were and are unsafe and unsound banking practices within the meaning of 12 U.S.C. § 1818 and were and are in violation of the laws and regulations governing the conduct of the business of national banks, as cited hereinabove.

/s/ John J. Mathias
John J. Mathias
Administrative Law Judge

June 27, 1980

EXHIBIT D

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF THE FIRST NATIONAL BANK OF SCOTIA, SCOTIA, NEW YORK; KENNETH E. BUHRMASTER; and LOUIS H. BUHRMASTER	Docket No. AA-EC-80-1

DECISION OF THE COMPTROLLER OF THE CURRENCY

The First National Bank of Scotia, Scotia, New York (hereinafter the "BANK"), Kenneth E. Buhrmaster and Louis H. Buhrmaster, as the respondents in this case, having been served with a Notice of Charges dated February 13, 1980, by the Office of the Comptroller of the Currency (hereinafter the "COMPTROLLER"), appeared through counsel at a hearing held commencing April 8, 1980, before the Honorable John J. Mathias, Administrative Law Judge ("ALJ"). On June 27, 1980, the ALJ

certified to the COMPTROLLER for decision the entire record of the hearing, including the ALJ's recommended decision, findings of fact, conclusions of law and recommended order, the hearing transcript, exhibits, rulings and all briefs and memoranda filed in connection with the hearing. Pursuant to a request from respondents' counsel and as permitted by 12 C.F.R. § 19.13, the COMPTROLLER heard oral argument on the ALJ's recommended decision on October 1, 1980. Upon receipt of the transcript of oral argument, the COMPTROLLER notified the parties that the case had been submitted to the COMPTROLLER for decision.

I. ADOPTION OF ALJ'S RECOMMENDED DECISION.

The COMPTROLLER, acting by virtue of the authority conferred upon him by 12 U.S.C. § 1818(b), hereby adopts as the decision of the COMPTROLLER the findings of fact, conclusions of law, and narrative summary of the

ALJ as stated in his recommended decision of June 27, 1980, with certain technical changes as follows: (1) The word "bank" should be substituted for the word "branch" in line 13, page 6 of the ALJ's decision. (2) The word "banks" should be substituted for the word "branches" in line 9, page 37 of the ALJ's decision. (3) The date "June 30, 1979" should be substituted for the date "June 30, 1978" in line 8, page 18. (4) The date "January 16, 1979" should be substituted for "January 16, 1980" in line 19-20, page 18. (5) The reference "RX 54" should be substituted for reference "CX 54" in line 1, page 37. These changes relate to typographical or technical errors, as is obvious from the context in which they appear.

II. ORDER TO CEASE AND DESIST.

Counsel for the COMPTROLLER's Enforcement and Compliance Division, who litigated

the case on behalf of the COMPTROLLER, filed Exceptions to the ALJ's recommended decision dated July 10, 1980. The primary focus of the Exceptions suggests that, based on the findings and conclusions of the ALJ, the BANK should be required to obtain a new chief executive officer. The COMPTROLLER has considered arguments advanced in the Exceptions and agrees that new leadership might help the BANK to more easily and quickly return to a safe and sound condition. However, in view of the various other remedies contained in the attached final order, the COMPTROLLER accepts the ALJ's recommendation that the BANK not be ordered to obtain a new chief executive officer.

Respondents have filed Exceptions to the ALJ's recommended decision and order, dated July 14, 1980, and a Brief, dated August 19, 1980, which focuses on the ALJ's proposed order. The Exceptions simply dispute in con-

clusory fashion virtually every finding of the ALJ and the conclusions and recommendations based thereon. No additional evidence, explanation or theory is offered to rebut the substantial evidence upon which the ALJ's decision is based.

Respondents' Brief challenges virtually all of the Articles in the ALJ's proposed order and raises, among others, the following three issues of fact or law:

(1) The BANK's condition has improved to such an extent that it needs to raise only $750,000, not $1.5 million, in additional equity capital.

(2) The ALJ's recommended order provisions requiring the BANK to raise $1.5 million in additional capital within a stated period of time or, failing that, to effectuate a sale or merger of the BANK, are impractical and overlook the statutory need for 2/3

shareholders approval before capital is raised or a merger consummated.

(3) The remedy relating to the Erie Boulevard branch property is inappropriate because the BANK does not hold title to the property and, furthermore, the BANK's payments as "lessee" have been more than fair to the BANK.

These three items are addressed in turn and under separate headings below.

Respondents' Brief makes additional claims and assertions relating to matters that the ALJ has already adequately considered or that are outside the record. With respect to non-record matters, the COMPTROLLER notes that a BANK's condition is never frozen in time but is always subject to change. However, in an administrative proceeding designed to correct conditions at a bank, including the need for additional equity capital, the record must be deemed com-

pleted at some point and an appropriate remedy must be fashioned upon that basis.

A. The BANK's Capital.

The COMPTROLLER did agree, pursuant to a stipulation of the parties (See Transcript of Oral Argument at 8-10), to accept for inclusion in the record the open part of the COMPTROLLER's Report of Examination, dated March 17, 1980 (marked as COMPTROLLER's Exhibit 86, CX86) for purposes of fashioning an appropriate remedy. Respondents' argument that the BANK has made significant improvements and that $750,000 in additional equity capital would be sufficient is not supported by the analysis and data contained in the March 17, 1980 Report of Examination. This report shows that the BANK remains in critical condition by virtue of its earnings record ($56,000 loss for the first two months of 1980, CX86-C), criticized loans (71.52% of

gross capital funds, as compared with 81.33% at the April 1979 Examination, CX86-M), criticized investments ($808,362 or 24.26% of gross capital funds, CX86-V), inadequate reserves for loan losses (loan losses totalled about $313,000 or 95% of the entire reserve, CX86-R), insufficient liquidity (CX86-X and Y), inadequate matching of rate-sensitive assets and liabilities, (CX86-X and Y), excessive personnel and occupancy expenses, (CX86-Z), and internal control, audit and other operational deficiencies (CX86-F, G, N, P, Q, DD, EE, GG, II, and JJ). 1/ The COMP-

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1/ Articles VII (allowance for possible loan losses), VIII (internal controls and internal and external audit), and IX (asset and liability management) of the COMPTROLLER's final order address problems that have plagued the BANK for some time. The COMPTROLLER's March 17, 1980 Report of Examination cites continuing deficiencies in each of these areas, as referenced in the text. Even if $1.5 million in additional equity capital is raised, the BANK must correct such management and operational deficiencies in order to be restored to a safe and sound condition.

TROLLER's order therefore retains the ALJ's recommendation that the BANK be required to raise an additional $1.5 million in equity capital.

B. The Need for Shareholder Approval.

In discussing Articles I and II of the ALJ's proposed order, respondents' Brief notes practical problems in raising additional capital and references the statutory need for approval of 2/3 of the BANK's shareholders before $1.5 million in additional capital could be raised or before the sale or merger of the BANK could be effectuated. The successful implementation of a program to raise $1.5 million in additional capital may or may not be difficult. However, based upon the condition of the BANK as evidenced by the record, the attempt must be made. If sufficient capital cannot be raised in a timely manner, then the Article II resort to a sale

or merger remains the only viable option.

Under 12 U.S.C. § 1818(b), the COMPTROLLER is granted authority to order a bank or its directors, officers, employees, agents and others participating in the conduct of affairs of the bank to "take affirmative action to correct the conditions resulting" from a violation of law or an unsafe or unsound banking practice. The affirmative action in this case is the raising of additional capital or, failing that, arrangement of a sale or merger. It is true that 12 U.S.C. § 57 authorizes a national bank to increase its capital stock upon approval of the COMPTROLLER and 2/3 vote of the shareholders, and that 12 U.S.C. §§ 214a and 215 authorize a national bank to merge or consolidate with another bank upon 2/3 vote of the shareholders and in accordance with certain other requirements. The COMPTROLLER's approval is required under 12 U.S.C. § 215 when the na-

tional bank is merging or consolidating with another national bank. However, these statutes are essentially permissive in nature and designed to afford protection to shareholders. Ordinarily, bank management initiates such corporate changes of its own volition and to accomplish its own business objectives. The merger and consolidation statutes (12 U.S.C. §§ 214a and 215) specifically set forth dissenting shareholders rights and valuation procedures. However, in the context of a cease and desist proceeding, these laws cannot be relied upon to defeat the COMPTROLLER's order directing that affirmative action be taken to restore the bank to a safe and sound condition and assure the protection of depositors' funds. Particularly in this case, where the Buhrmasters and their interests are in effective control of the BANK, such a reading would destroy the utility of 12 U.S.C. § 1818(b), which Con-

gress enacted in 1966 as a remedial measure short of the more drastic action of termination of a national bank's insured status or revocation of its charter. See 12 U.S.C. § 1818(a) and 12 U.S.C. § 93 respectively. See also respondents' Offering Circular dated December 5, 1978, CX11-S, wherein K. E. Buhrmaster, L. H. Buhrmaster, J. R. Buhrmaster, F. S. Buhrmaster, and L. A. Buhrmaster, all residing in Scotia, New York, are listed as beneficial owners of 71% of the BANK's stock.

C. The Erie Boulevard Branch.

The third and final item of respondents' Brief addressed here relates to the Erie Boulevard branch. Respondents' claim that since legal title to the property rests with the J. H. Buhrmaster Company, not the BANK, there has been no violation of 12 U.S.C. § 371d and the BANK cannot be ordered to sell the branch. Respondents further claim that the

BANK's payments as "lessee" have been more than fair to the BANK.

The COMPTROLLER's final order modifies the ALJ's proposed remedies in two respects. Paragraph (4) of the ALJ's proposed order required the BANK to correct its violation of 12 U.S.C. § 371d by one of three means. The alternative set forth in subparagraph (4)(b) provided for the BANK to sell its branch located at 120 Erie Boulevard, Schenectady, New York, under terms and conditions acceptable to the Regional Administrator. Recognizing that title is currently in the name of the J. H. Buhrmaster Company, the COMPTROLLER's subparagraph (4)(b) provides for the BANK to formally assume title for purposes of selling the branch.

Paragraph (5) of the ALJ's proposed order required the BANK to retain an outside auditor to determine the amount of the BANK's investment in the Erie Boulevard branch. The

BANK's investment was defined to include all payments for land, construction, easements, rent, repairs, maintenance, depreciation, loans, interest, taxes, legal fees, insurance, and any other items associated with the establishment and maintenance of the branch. This formulation would make it possible for the BANK to have occupied the premises rent-free for the duration of its occupancy. The COMPTROLLER believes that a more reasonable method of determining the BANK's investment in the Erie Boulevard branch is to calculate the BANK's original costs for development and leasehold improvements, plus any rental payments determined by the auditor to be in excess of fair market rental, less any depreciation of the leasehold improvements determined under generally accepted accounting principles. The COMPTROLLER's revision of Paragraph (5) is responsive to respondents' claim that the BANK's payments as "lessee"

have not been excessive.

Having made these changes in the final order, the COMPTROLLER agrees with the ALJ's basic finding that the Buhrmasters utilized their family-owned company as the BANK's alter ego to accomplish indirectly what the BANK could not do directly, namely an investment in bank premises in excess of the 12 U.S.C. § 371d capital limitations. See ALJ's decision at 20-24. The fact that the J. H. Buhrmaster Company currently holds title to the property does not defeat this finding.

III. CONCLUSION

In addition to the changes already discussed, the COMPTROLLER's attached final order departs in a number of other respects from the ALJ's proposed order. The changes mostly reflect the passage of time or the inclusion in the record of the COMPTROLLER's

March 17, 1980 Report of Examination. The COMPTROLLER also takes note of the fact that the BANK has apparently hired a new senior lending officer. Although this information is not part of the record in the case, the COMPTROLLER believes that the new individual should be allowed to remain if found qualified by the Regional Administrator. The COMPTROLLER has modified Article III of the ALJ's proposed order to provide for additional flexibility. The attached final order, generally comparable to but adopted in lieu of the ALJ's proposed order, is part of the COMPTROLLER's decision.

/s/ Lewis C. Odom, Jr.
Lewis C. Odom, Jr.
by designation
Acting Comptroller of the
Currency

Dated: 20 Nov. 1980

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF THE FIRST NATIONAL BANK OF SCOTIA, SCOTIA, NEW YORK; KENNETH E. BUHRMASTER; and LOUIS H. BUHRMASTER	Docket No. AA-EC-80-1

A Cease and Desist Order against the First National Bank of Scotia, Scotia, New York, its directors, employees, and agents, collectively; and Kenneth E. Buhrmaster and Louis H. Buhrmaster, individually.

ORDER TO CEASE AND DESIST

WHEREAS, the First National Bank of Scotia, Scotia, New York (hereinafter "BANK"), Kenneth E. Buhrmaster, and Louis H. Buhrmaster, having appeared at an administrative hearing held before the Honorable John J. Mathias, Administrative Law Judge, which hearing litigated the accuracy and sufficiency of a Notice of Charges issued against the BANK,

Kenneth E. Buhrmaster, and Louis H. Buhrmaster pursuant to 12 U.S.C. § 1818(b) by the Comptroller of the Currency of the United States of America (hereinafter "COMPTROLLER");

WHEREAS, the COMPTROLLER, based on the record of the hearing and the recommended decision, findings of fact and conclusions of law of the Administrative Law Judge, finds that unsafe and unsound banking practices and violations of law, rule and regulation cited in the Notice of Charges have been proven and that these practices and violations warrant the issuance of this Order to Cease and Desist;

NOW, THEREFORE, the COMPTROLLER, acting by virtue of the authority conferred on him by 12 U.S.C. § 1818(b), hereby ORDERS THAT:

ARTICLE I

(1) Within thirty (30) days of the effective date of this ORDER, the BANK shall

submit to the Regional Administrator of National Banks for the Second National Bank Region, New York, New York (hereinafter "REGIONAL ADMINISTRATOR"), for his approval, a program to raise at least one million five hundred thousand dollars ($1,500,000) in new equity capital within one hundred and twenty (120) days of said effective date. If the REGIONAL ADMINISTRATOR disapproves the program for any reason, the BANK shall promptly amend the program in accordance with the REGIONAL ADMINISTRATOR's comments and shall continue to re-submit it until the REGIONAL ADMINISTRATOR approves it. Upon written notification of the REGIONAL ADMINISTRATOR's approval, the BANK shall promptly implement and strictly adhere to the program.

ARTICLE II

(2) If the BANK is unable to develop an acceptable program to raise $1,500,000 in new equity capital within one hundred and twenty

(120) days of the effective date of this ORDER, or is unable to implement such a program within two hundred and forty (240) days of the effective date of this ORDER, the Board of Directors of the BANK shall immediately submit realistic proposals to the REGIONAL ADMINISTRATOR for the sale or merger of the BANK.

ARTICLE III

(3) The BANK shall immediately submit to the REGIONAL ADMINISTRATOR for his review the name and background of the BANK'S Senior Lending Officer who shall have primary responsibility for the overall lending functions of the BANK. If the REGIONAL ADMINISTRATOR decides that the individual is not qualified for the position, the BANK shall, within one hundred and twenty (120) days of the effective date of this ORDER, employ a new, capable and experienced Senior Lending Officer whose qualifications have been re-

viewed by the REGIONAL ADMINISTRATOR. Failure by the REGIONAL ADMINISTRATOR to exercise power of veto over the current or a new Senior Lending Officer shall not constitute an approval or endorsement of the officer.

ARTICLE IV

(4) Within one hundred and eighty (180) days of the effective date of this ORDER, the BANK, Kenneth E. Buhrmaster and Louis H. Buhrmaster shall correct the outstanding violation of 12 U.S.C. § 371d by:

(a) injecting sufficient equity capital into the BANK to satisfy the provisions of 12 U.S.C. § 371d; or

(b) causing the J. H. Buhrmaster Company to transfer title to the property located at 120 Erie Boulevard, Schenectady, New York, to the BANK for the purpose of selling said

property, under terms and conditions acceptable to the REGIONAL ADMINISTRATOR; or

(c) any other method acceptable to the REGIONAL ADMINISTRATOR.

(5) The BANK shall retain an independent, outside, qualified auditor acceptable to the REGIONAL ADMINISTRATOR to determine the exact amount of the BANK's investment in the Erie Boulevard branch. For the purposes of this Article, the BANK's investment shall be defined to include its original costs for development and leasehold improvements, plus any rental payments determined by the auditor to be in excess of fair market rental for the space occupied by the BANK, less any depreciation of the leasehold improvements determined under generally accepted accounting principles.

(6) If, in correcting the violation, the BANK does not recover its full investment in the branch, as determined in Paragraph 5 above, Kenneth E. Buhrmaster and Louis H. Buhrmaster shall indemnify the BANK for the amount of the investment not recovered. The Buhrmasters, however, shall not borrow, either directly or indirectly, from the BANK in order to make any required indemnification.

(7) Effective immediately, the BANK shall cease paying for the following items:

(a) taxes assessed on land owned by the Sanrit Realty Corporation;

(b) easement rights over land owned by the J. H. Buhrmaster Company or the Sanrit Realty Corporation; and

(c) depreciation expenses taken by the J. H. Buhrmaster Company.

ARTICLE V

(8) The BANK shall not violate the provisions of 12 U.S.C. § 371d in the future.

(9) The BANK shall promptly implement adequate policies and procedures to ensure that it does not violate the provisions of 12 U.S.C. § 371d in the future.

ARTICLE VI

(10) The BANK shall not loan additional money or otherwise extend credit to any borrower whose loan or other extension of credit has been criticized in whole or in part in the Report of Examination, dated April 16, 1979, or in any subsequent Reports of Examination, so long as the credit remains criticized or uncollected.

(11) The preceding paragraph shall not be deemed applicable if failure to take

such action by the BANK would be substantially and critically detrimental to its best interests. Before any such action is taken, however, the Board of Directors shall place in the credit file of the borrower a statement, signed by a majority of the directors, detailing why such action is deemed necessary.

ARTICLE VII

(12) The Board of Directors shall ensure that the BANK's Allowance for Possible Loan Losses is maintained at an adequate level in relation to the risk inherent in the BANK's loan portfolio.

(13) The Board of Directors shall conduct quarterly reviews to determine the adequacy of the BANK's Allowance for Possible Loan Losses. These reviews shall be comprehensive and shall focus particular attention on the following factors:

(a) loan loss experience; and

(b) an estimate of potential loss exposure on each significant credit.

The Board of Directors' analysis of the Allowance shall be fully supported by a written summation and documentation, as set forth in the April 16, 1979 Report of Examination, as supplemented or modified in the March 17, 1980 Report of Examination. The Board of Directors shall submit the summary of its review to the REGIONAL ADMINISTRATOR no later than 20 days after the end of each quarter.

(14) If, after his review, the REGIONAL ADMINISTRATOR determines that the Allowance is inadequate in relation to the risk inherent in the BANK's loan portfolio, the Board of Directors shall immediately make additional provisions.

ARTICLE VIII

(15) Within sixty (60) days of the effective date of this ORDER, the BANK shall

develop and implement a plan to correct the internal control exceptions noted in the April 16, 1979 Report of Examination, as supplemented or modified in the March 17, 1980 Report of Examination.

(16) Within ninety (90) days, the Board of Directors shall employ a full-time internal auditor who shall be solely responsible to the Board of Directors. Also, within one hundred twenty (120) days, the Board of Directors, with the assistance of the new internal auditor, shall formulate comprehensive plans for an internal audit program acceptable to the REGIONAL ADMINISTRATOR.

(17) The BANK shall have a comprehensive external audit of the BANK performed on an annual basis.

ARTICLE IX

(18) Within thirty (30) days of the effective date of this ORDER, the Board of Directors shall submit an acceptable writ-

ten asset and liability management program to the REGIONAL ADMINISTRATOR for his approval to reduce the BANK's reliance upon rate sensitive deposits and borrowed funds.

ARTICLE X

(19) The BANK shall not declare or pay any dividend except:

(a) in conformity with 12 U.S.C. § 60;

(b) when justified by sound banking policies; and

(c) with the prior written approval of the REGIONAL ADMINISTRATOR.

(20) Within sixty (60) days of the effective date of this ORDER, the Board shall formulate a written program, acceptable to the REGIONAL ADMINISTRATOR, to restore and satisfactorily maintain the earnings of the

BANK. Such program shall include a detailed monthly budget for 1981 and 1982 and shall include, but not be limited to, the following specific terms:

(a) measures to increase net interest earnings; and

(b) measures to reduce occupancy and personnel expenses.

(21) The budget shall detail all proposed balance sheet and income and expense items for the year 1981 and 1982. In addition, the BANK shall forward to the REGIONAL ADMINISTRATOR, at the end of each month, a balance sheet and profit and loss statement for the month and year to date, with comparative figures for the same period in the preceding year as well as for the budgeted amounts for 1979.

(22) The BANK shall not increase any salaries, expenses, or fees for its present executive officers and directors without the prior written approval of the REGIONAL ADMINISTRATOR.

ARTICLE XII

(23) Within thirty (30) days of the effective date of this ORDER, and on a monthly basis thereafter, the BANK shall provide the REGIONAL ADMINISTRATOR with the following progress reports:

(a) past due loan summaries;

(b) status reports on all criticized assets; and

(c) reconcilements on the Allowance for Possible Loan Losses.

ARTICLE XIII

(24) The BANK shall promptly implement adequate policies and procedures to ensure that in the future it does not violate the provisions of:

(a) 12 C.F.R. § 1.8;

(b) 12 C.F.R. § 7.3025; and

(c) 31 C.F.R. § 103.33(a).

ARTICLE XIV

(25) The Board of Directors of the BANK shall promptly appoint a Compliance Committee composed of three directors who are not officers of the BANK. This Committee shall have the responsibility of ensuring compliance by the BANK with the provisions of this ORDER. Within thirty (30) days of the effective date of this ORDER, and on a monthly basis thereafter, the Committee shall

submit to the REGIONAL ADMINISTRATOR detailed progress reports setting forth the actions taken by the BANK to comply with the provisions of this ORDER and the results of those actions.

ARTICLE XV

(26) The provisions of this ORDER shall become effective thirty (30) days after service of this ORDER by the COMPTROLLER, and shall remain effective and enforceable, except to the extent that, and until such time as, any provisions of this ORDER shall have been amended, suspended, waived, or terminated by the COMPTROLLER.

It is so ORDERED this 20 day of November, 1980.

/s/ Lewis C. Odom, Jr.
Lewis C. Odom, Jr.
be designation
Acting Comptroller of the
Currency

EXHIBIT E

AGREEMENT made April 11, 1974, between FIRST NATIONAL BANK OF SCOTIA, a National Banking Association, duly organized and existing under and by virtue of the Laws of the United States, with principal office at 201 Mohawk Avenue, Village of Scotia, Schenectady County, New York, hereinafter called "Bank" and J. H. BUHRMASTER CO., INC. of 421 Sacandaga Road, Village of Scotia, Schenectady County, New York, hereinafter called the "Developer";

WITNESSETH:

WHEREAS, the Developer acquired the real estate hereinafter described for development and use as a branch banking facility for the Bank as more fully described in this agreement and the accompanying documents; and

WHEREAS, the Developer, having been fully informed of the Bank's intent and desires with respect to the development and use of such real estate, on its own initiative

proposed that the Developer would cause the same to be developed and used in the manner hereinafter set forth, and would give the Bank the assurances so to do;

It is therefore, agreed between the parties as follows:

ARTICLE I

DESCRIPTION OF LANDS AND RESPONSIBILITIES

Section 1.1. Land. All that certain lot, piece or parcel of land lying and being in the city of Schnectady, County of Schenectady on the South Side of Erie Boulevard as described in Exhibit "A".

Section 1.2. Bank agrees that it will subordinate, if required, its interest in the lease described in Section 3.3(a) to any first mortgage obtained by Developer in connection with the above.

Section 1.3. Builders Risk Insurance. Developer shall be responsible for builders

risk insurance related to the property and improvements thereon from date hereof to date of closing; Bank shall reimburse the Developer for this cost when the Bank accepts possession.

Section 1.4. Cost of Closing Mortgate, Developer shall be responsible for the expense of abstract of title bringdown, recording deeds, recording mortgages, permits, mortgage taxes, interim financing, and attorney fees. Bank shall reimburse the Developer for these costs when the Bank accepts possession.

Section 1.5. Interim use of Premises. The Bank has previously undertaken the use of part of the premises for banking purposes and shall continue such use until a closing can be held in respect of the new building in accordance with Artile III hereof. Such use has required the acquisition of land, payment of taxes, insurance coverage, demolition of

buildings, preparation of site, installation of services and location of a temporary bank building owned by the Bank. As rental for such use during the interim period the Bank shall pay Developer all sums expended by Developer for taxes, insurance, interest on money used to purchase land, development of site and provision of services and equipment for temporary bank building; and the Bank shall also pay to Developer all sums expended by the Developer on account of the purchase of that portion of the premises acquired from Sanrit Realty Corporation including payments on the existing mortgage of Sanrit Realty Corporation covering such premises. All sums paid by the Bank to reimburse the Developer for expenditures to acquire the Sanrit Realty Corporation land including the principal portion of the mortgage payments in respect of such land, shall be credited to the Bank in completing the purchase price to be paid by

the Bank under the option to purchase set forth in Section 3.3(a) hereof.

ARTICLE II

DEVELOPMENT OF PROPERTY

Section 2.1. Plans and Specifications. The Bank has previously prepared and delivered to the Developer, and each has approved and initialed, outline plans and specifications for the construction of the Bank's building. As used in this agreement, the term "Bank's building" means the Tenants building--including building equipment--to be erected and installed according to such plans and specifications, a copy of which are attached hereto as Exhibit "B". Total cost to construct Bank's building shall not exceed Two Million Five Hundred Fifty Thousand Dollars ($2,550,000) including non recurring expenses and interim cost of financing.

Section 2.2. Changes to Plans. Changes to plans may be made upon the mutual consent

of both parties in accordance with the procedure set forth in Section 2.3 below and shall be paid for by Bank in accordance with this agreement.

Section 2.3. Costs of Changes to Plans. In the event changes are made to the plans and specifications, which increase or decrease the purchase price set forth in Section 2.1; Developer shall advise Bank as follows:

(a) Developer shall provide revised drawings and descriptions of any changes which shall be approved by Bank's architect and shall be accompanied by an estimate of the total cost, including architect fees, to accomplish such changes;

(b) Such estimate, as submitted, may be approved in writing by the Bank and returned to the Developer within ten (10) days after receipt thereof by the Bank, in which case the Bank agrees to reimburse the Developer

under this agreement for the aggregate net increase in architects' and engineers' fees and in construction costs, if any, shown on all of such approved estimates;

(c) Developer shall not be reimbursed for any changes not approved by Bank.

(d) Developer will provide necessary building permits.

ARTICLE III

CLOSING

Section 3.1. Place of Closing. All matters to be performed under this agreement on the closing date shall be performed at the office of McGivern, Mills & Shaw, Ten Broeck Street, Scotia, New York, on the closing date.

Section 3.2. Date of Closing. The closing date shall be March 1, 1975 provided the Developer is not in default under this agreement, and at the time of giving the notice next mentioned if the Developer gives

such notice, all matters hereunder to be done or performed prior to the closing date, except those to be done or performed by the Bank, have been done or performed, the Developer, upon twenty (20) days prior written notice to the Bank setting forth an earlier closing date, may accelerate the closing date, in which event the earlier date mentioned in such notice shall be the closing date hereunder. The closing date may be extended upon mutual agreement of the parties.

Section 3.3. Documents. On the closing date, provided that all matters hereunder to be done or performed then or prior thereto shall have been duly done and performed;

(a) The Bank and the Developer shall duly execute, acknowledge, and deliver, as Lessor and Lessee, respectively, a lease, including but not limited to:

A monthly rental, during the original lease term, in the amount required to amor-

tize the mortgage on the premises, not to exceed 2,500,000 dollars; the interest cost of the Developer on all funds advanced to purchase land for the Bank and not reimbursed to Developer from mortgage proceeds; all payments required to be made to Sanrit Realty Corporation by the Developer in connection with the acquisition of the Sanrit property, leases and easements. An annual rental in the amount of any taxes, insurance premiums, repairs, maintenance and other carrying costs paid by the Developer and not reimbursed by the Bank prior to the end of the year including the depreciation expense of the Developer based on a forty year depreciation of the building and improvements, together with the actual costs to Developer of labor and services supplied to the premises for the benefit of the Bank, but not to exceed an amount equal to 1% of the original amount of the principal mortgage.

Provision requiring the Bank to provide adequate insurance coverage, both liability and casualty, for the benefit of the Bank, the Developer and the Mortgagee, as interests may appear; and to pay all property taxes and assessments when the same shall become due.

Provision whereby the Bank may sub-lease all or part of the premises only upon the written approval of Developer, which approval shall not be unreasonably withheld; but Bank shall thereafter remain liable for all rent and obligations without any claim of attornment on account of the Developers consent to sub-leasing.

Provision whereby the Bank may, at any time during the original term of the lease and any renewals, have sole option and right to purchase the leased premises at a cost equal to the Developers cost of acquiring the land and developing it, excluding any of such costs paid directly by the Bank or reimbursed

to the Developer, plus the depreciated value of improvements thereon at the time of purchase, but in no event shall the purchase price be less than the Developers cost of land, less reimbursement, and the balance of principal and interest on the mortgage. Such option may only be exercised when the Bank is current with respect to all payments due the Developer in accordance with this agreement.

Provision whereby the Bank may make such additions and improvements as it deems advisable for its own benefits or the benefit of others, provided that the same shall not diminish the value of the premises nor violate any laws, ordinances, mortgage provisions or land restrictions.

Provision whereby the Bank shall keep the premises free and clear of all liens and encumbrances during the term of the lease and any renewals; and the Developer shall, likewise, not suffer any liens or encumbrances to

be charged upon the premises, except for the original mortgage as herein provided.

Provision whereby the original term of the lease shall be at least equal to the terms of the mortgage herein provided.

(b) The Developer shall obtain for the Bank rights of way over and through the Developer land known as the Penn Central property and the lands of D.D. Montana known as Sun Property, and the Bank shall reimburse the Developer for the actual costs thereof.

(c) The Developer will apply for a first mortgage on the premises in an amount of 2,500,000 dollars to provide the funds necessary to complete the bank premises as contemplated by the parties. In the event that the Developer is unable to obtain a mortgage commitment in such amount, upon reasonable terms, the Developer shall proceed to mortgage the premises for the maximum amount for which a commitment can be obtained. This

shall be the first and only mortgage on the premises, and the parties shall revise the building plans so that the Developer shall not be required to expend a total amount in excess of the mortgage proceeds plus the amounts already expended to acquire the land, less payments in respect of the Sanrit Realty Corporation property which have or will be made by the Bank. Nothing herein shall, however, prevent the Bank from continuing with the building plans agreed upon provided the the Bank shall directly pay for the costs of completing the building to the extent they shall exceed the limitation on the amounts to be expended by the Developer.

(d) The Bank and the Developer shall make, execute and deliver such leases, deeds, mortgages, contracts, easements and other documents as may be necessary or desireable to carry out the terms of this agreement; provided that no such document or instrument

shall contain terms or conditions at variance with the terms and conditions of this basic agreement, nor shall they be deemed to have amended this agreement unless they contain language required by Section 4.6 hereof. Any agreements or undertakings hereafter made by either or both parties which shall impose greater burdens upon or reduce benefits due to either party, without a corresponding amendment of this basic agreement, shall be null and void as between the parties and the other party shall save harmless the party so burdened or divested of benefits.

ARTICLE IV

MISCELLANEOUS

Section 4.1. Notices. Any notice, request or demand given or required to be given under this agreement shall, except as otherwise expressly provided herein, be in writing and shall be deemed to have been given when mailed by registered mail, postage prepaid,

to the other party at the address stated below or at the last changed address given by the party to be notified as hereinafter specified:

To the Developer: by address the same to

J. H. Buhrmaster Co., Inc.
421 Sacandaga Road
Scotia, NY 12302

To the Bank: by addressing the same to

First National Bank of Scotia
201 Mohawk Avenue
Scotia, NY 12302

Either party may, however, at any time, change its address for notification purpose by mailing as herein provided a notice stating the change and setting forth the new address.

Section 4.2. Assignment. Developer may not assign his right, title and interest in this agreement without the written consent of the Bank.

Section 4.3. Waivers. No delay or omission by either party hereto to exercise any right or power accruing upon any noncompliance or default by the other party with respect to any of the terms of this agreement shall impair any such right or power to be construed to be a waiver thereof, except as otherwise herein provided. A waiver by either of the parties hereto of any of the covenants, conditions, or agreements hereof to be performed by the other shall not be construed to be a waiver of any succeeding breach thereof or of any other covenant, condition or agreement herein contained.

Section 4.4. Article and Section Headings. The article and section headings are for convenience and reference only, and in no way define or limit the scope of this agreement or in any way affect its provisions.

Section 4.5. Applicable Law. This agreement shall be governed by and construed

in accordance with the laws of the State of New York.

Section 4.6. Entire Agreement. This agreement contains the entire agreement between the parties and any agreement hereafter made shall be ineffective to change, modify, or discharge this agreement, in whole or in part, unless such agreement shall refer specifically to this agreement and shall designate clearly the article and section to be amended and the wording to be omitted or added to such article and section. Such agreement must be in writing and signed by the parties hereto.

Section 4.7. Execution in Counterparts. This agreement may be executed in several counterparts, each of which shall be deemed an original, and all such counterparts shall together constitute but one and the same instrument.

In witness whereof the parties hereto have duly executed this agreement as of the day and year first mentioned above.

Attest: FIRST NATIONAL BANK OF SCOTIA

/s/ B. T. McGivern BY: /s/ (illegible)

J. H. BUHRMASTER CO., INC.

BY: /s/ James R. Buhrmaster

STATE OF NEW YORK :

: ss.:

COUNTY OF SCHENECTADY :

On this 11 day of April, 1974, before me personally came LOUIS H. BUHRMASTER, to me know, who, being by me, duly sworn, did depose and say that he resides at Scotia, New York; that he is the President of the FIRST NATIONAL BANK OF SCOTIA, the corporation described in and which executed the above instrument; that he knows the seal of said corporation; that the seal affixed to said instrument is such corporate seal; that it was so affixed by order of the Board of Directors of said corporation; and that he signed his name thereto by like order.

/s/ Bernard T. McGiven
Notary Public - State of New York
Commission Expires: 3/30/76

STATE OF NEW YORK :

: ss.:

COUNTY OF SCHENECTADY :

On this 11 day of April, 1974, before me personally came JAMES R. BUHRMASTER, to me known, who, being by me, duly sworn, did depose and say that he resides at Scotia, New York; that he is the President of the J. H. BUHRMASTER CO., INC., the corporation described in and which executed the above instrument; that he knows the seal of said corporation; that the seal affixed to said instrument is such corporate seal; that it was so affixed by order of the Board of Directors of said corporation; and that he signed his name thereto by like order.

/s/ Bernard T. McGivern
Notary Public - State of New York
Commission Expires: 3/30/76

SCHEDULE B

1 - Set of plans of building for
First National Bank of Scotia
120 Erie Boulevard, Schenectady, NY

1 - Set specifications for above

SCHEDULE A

ALL THAT CERTAIN PIECE, TRACT OR PARCEL OF land, with the buildings thereon, on the southerly side of Erie Boulevard in the City and County of Schenectedy, State of New York, more particularly bounded and described as follows:

Commencing at a point where the common boundary line between lands now or formerly of the General Electric Company and the lands of J. H. Buhrmaster Co., Inc., intersects the southerly boundary of Erie Boulevard aforesaid, and running thence N. 59°42'30" east along said southerly boundary of Erie Boulevard a distance of 48.02 feet to a point; and running thence S. 28°48'30" east along lands now or formerly of Anthony E. Cipriano a distance of 178.32 feet to a point; and running thence N. 64°24'30" east a distance of 52.08

feet to a point; and running thence N. 28°48'30" west 182.59 feet to the southerly boundary of Erie Boulevard aforesaid; and running thence N. 59°42'30" east 209.54 feet to lands now or formerly of Lowenberg; and running thence S. 29°27'20" east 199.92 feet along the lands of said Lowenberg to a point; and running thence N. 64°24'30" east a distance of 55.12 feet to a point; and running thence S. 28°48'30" east 111.28 feet to a point; and running thence S. 53°45'50" west a distance of 369.86 feet to a point and running thence N. 28°48'30" west a distance of 354.09 feet to the point or place of beginning.

Being and intended to be all of those certain premises conveyed to Ronald R. Shaw by three warranty deeds from Sam S. Schabet; and all of the premises owned by the Sanrit Realty Corporation.

Opposition

Office - Supreme Court, U.S.
FILED
OCT 14 1981
ALEXANDER L. STEVAS,
CLERK

No. 81-322

In the Supreme Court of the United States

OCTOBER TERM, 1981

THE FIRST NATIONAL BANK OF SCOTIA, ET AL.,
PETITIONERS

v.

UNITED STATES DEPARTMENT OF THE TREASURY, ETC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENTS IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

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THE FIRST NATIONAL BANK OF SCOTIA, ET AL., PETITIONERS

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UNITED STATES DEPARTMENT OF THE TREASURY, ETC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENTS IN OPPOSITION

Petitioners, The First National Bank of Scotia and two of its officers, Kenneth E. Buhrmaster and Louis A. Buhrmaster, brought this action to review a cease and desist order issued by the Comptroller of the Currency pursuant to 12 U.S.C. 1818 (Pet. App. A-2). The cease and desist order was issued after extensive administrative proceedings, in which it was established that petitioners had engaged in various unsound banking practices (see Pet. App. C-8 to C-10), including an excessive investment in the bank's Erie Boulevard premises in Schenectady, New York, in violation of 12 U.S.C. 371d.[1] The Comptroller's final

[1] 12 U.S.C. 371d provides in pertinent part:

> No national bank, without the approval of the Comptroller * * * shall * * * invest in bank premises, or in the stock, bonds, debentures or other such obligations of any corporation holding the premises of such bank * * * if the aggregate of all such investments * * * will exceed the amount of the capital stock of such bank.

decision and order (Pet. App. D-1 to D-32) were affirmed by the court of appeals (*id.* at A-1 to A-9). Petitioners, who now challenge only that aspect of the Comptroller's decision dealing with the Erie Boulevard branch investment, contend (Pet. 8-18) that the decision below conflicts with this Court's decision in *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978).

1. The facts relevant to the Erie Boulevard transaction are fully stated in the recommended decision of the administrative law judge (Pet. App. C-52 to C-70), which was upheld in relevant part by the Comptroller (*id.* at D-12 to D-15). Essentially, petitioner bank had insufficient capital to permit its investment in a branch bank under 12 U.S.C. 371d. Thus, petitioner bank and J. H. Buhrmaster Co. entered into an agreement (Pet. App. E-1 to E-23) whereby the bank would lease the Erie Boulevard premises, with an option to buy. The Comptroller found (*id.* at D-15):

> [T]he Buhrmasters utilized their family-owned company as the BANK's alter ego to accomplish indirectly what the BANK could not do directly, namely an investment in bank premises in excess of the 12 U.S.C. § 371d capital limitations.

As part of the cease and desist order, the Comptroller ordered that petitioners either: (1) bring the bank's equity capital up to the level required by 12 U.S.C. 371d, or (2) cause the title to the Erie Boulevard property to be transferred from the family-owned company to the petitioner bank for the purpose of selling the premises under terms acceptable to the Comptroller's regional administrator, or (3) correct the violation of Section 371d in some other method acceptable to the regional administrator (Pet. App. D-21 to D-22).

The court of appeals affirmed the Comptroller's order (Pet. App. A-1 to A-9), holding that substantial evidence supported the finding of a violation of Section 371d (*id.* at A-6 to A-7).

2. Petitioners seek review in this Court based solely on the ground that the decision below conflicts with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). No such conflict exists, however, because the two cases are clearly distinguishable. In *Frank Lyon*, the Court addressed the question whether, for federal income tax purposes, the lessor in a particular sale-and-leaseback transaction had retained sufficient attributes of ownership to deduct depreciation expenses. The Court in *Frank Lyon* did not purport to interpret the language of 12 U.S.C. 371d or otherwise address the circumstances in which a sale-and-leaseback arrangement would be permissible under this statute. At all events, petitioner's claim that the transaction in *Frank Lyon* was "virtually identical" (Pet. 9) to the transaction at issue here is incorrect.[2]

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[2] Some of the most significant differences are set forth below:

Lyon	*Scotia*
Sale-leaseback arrived at only after competitive arms-length negotiations with a number of disinterested firms (435 U.S. at 564-565).	Sale-leaseback arrived at through family business; no competitive negotiations for opportunity to lease building to bank (Pet. App. C-53).
Arrangement arrived at with knowledge and specific approval of regulatory officials (435 U.S. at 565).	Existence of terms of true "leasing" arrangement concealed from regulator with express purpose of avoiding consequences of Section 371d (Pet. App. A-7 to A-8; C-57 to C-61).

[Footnote continued on page 4]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

OCTOBER 1981

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[2] [Continued]

Lessor advanced $500,000 in "ownership equity" to cover unfinanced construction costs (*Lyon* v. *United States*, 536 F.2d 746, 748 (8th Cir. 1976), rev'd, 435 U.S. 561 (1978)).	Lessee (bank) assumes responsibility for and pays $500,000 in unfinanced construction costs (Pet. App. C-56).
Lessee had option to purchase but only at specified times and at specified prices (435 U.S. at 567).	Lessee has option to purchase at any time and at cost (Pet. App. A-7; C-55).
Formal lease documents prepared and followed (435 U.S. at 566).	Formal lease promised but never executed (Pet. App. E-7 to E-8; C-54).
Lessor extracted some business benefit in the form of tax write-offs and more favorable interest rate on subsequent unrelated loan to lessee (435 U.S. at 582).	Lessor realizes no apparent business benefit from arrangement; it acts only as a conduit for payment (Pet. App. A-7; C-54 to C-55).
Lessor exposed to risk of substantial loss if certain options not exercised by lessee (435 U.S. at 577, 579).	Except for possibility of bank failure, lessor exposed to no apparent risk of loss—even "book loss" (Pet. App. A-7; C-55).
Entire arrangement characterized as a bona fide arms-length business transaction (435 U.S. at 575).	Arrangement found to be a "sham" transaction with only one purpose in mind—to avoid the consequences of Section 371d (Pet. App. A-7 to A-8; C-56 to C-61).

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